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INSURANCE COMPANY SOLVENCY

HEARINGS

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

FEBRUARY 27, AND MAY 7, 9, AND 23, 1991

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INSURANCE COMPANY SOLVENCY

WEDNESDAY, FEBRUARY 27, 1991

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
Washington, DC.

The committee met, pursuant to notice, at 9:37 a.m., in room SR–253, Hon. Richard Bryan, presiding.

Staff members assigned to this hearing: Moses Boyd and Linda Lance, professional staff members; and Alan Maness and Sherman Joyce, minority professional staff members.

OPENING STATEMENT BY SENATOR BRYAN

Senator BRYAN. Good morning ladies and gentlemen, and it is my pleasure to welcome you to the full hearing of the Commerce Committee this morning. The purpose of today's hearing is to examine the threat of insolvency to the insurance industry. This is part of an overall effort by the full Commerce Committee to evaluate the health and the stability of our Nation's insurance system.

Insurance plays a vital role in our modern society. According to the most recent information released by the Insurance Information Institute the total insurance written for all lines equal $453 billion.

The underlying premise of the insurance contract is the premium payment made in advance by the policyholder in exchange for a promise by the insurer to pay in the name of the insured all or part of the costs associated with respect to a particular future event. There are some indications, however, that this promise to pay may be in jeopardy.

There have been a growing number of insolvencies within the insurance industry both among property, casualty, and life-health companies. From 1969 to 1983, there was an average of approximately four insolvencies per year in the insurance industry. However, since that time the average numbers of insolvencies in the industry has increased to more than 20 per year and is beginning to involve much larger companies.

In addition, there has been a dramatic increase in the number of companies needing special regulatory attention. This is a designation for companies that are not insolvent but are showing signs of possible financial trouble. Reports show that from 1978 to 1987, the property casualty companies needing special regulatory attention increased from 8.4 to 21.4 percent in the industry.

Unlike thrifts and commercial banks there are no Federal depository insurance funds to protect policyholders and claimants in the event an insurer fails. Most States, however—nearly all—have established special guaranty funds to provide coverage to policyholders of failed companies.

The funds are collected from assessments of all companies doing business in the respective States. Reports show that as a result of the substantial increase in company insolvency, guaranty fund assessments increased from $82 million in 1984 to close to $1 billion in 1988. This burden is not borne by insurance companies alone, because in most States such assessments are recouped by companies either through direct surcharges on policyholders or tax credits and deductions, ultimately leaving much of the bill to be paid by policyholders and taxpayers.

The purpose of today's hearing is to provide the committee with an opportunity to inquire into the overall financial health of the insurance industry. The committee's purpose this morning will be twofold: first, to examine the parallels, if any, that exist between the financial condition of the insurance industry and that confronting the savings and loan industry several years ago, and second to look at the quality of the regulatory oversight of the insurance industry.

Our first panel will consist of representatives of the U.S. Department of Commerce and the U.S. General Accounting Office. Both agencies have conducted analyses of the industry and are here this morning to share their work with us.

Our second panel is composed of several industry analysts and representatives of insurance rating companies who will give us assessments of the current conditions of the insurance industry. We will conclude this morning with the third panel, which will include several academicians who have studied the current conditions in the industry, and finally we will hear from a representative of the National Association of Insurance Commissioners, the organization which represents State insurance regulators, and I would note for the record that it would be the intention of the committee to conduct at least one followup hearing to today's hearing as well.

We will begin this morning's proceeding with the first panel, Miss Linda Powers, the Deputy Assistant Secretary for Services, the Department of Commerce, and Johnny C. Finch, Director for Planning and Reporting from the General Accounting Office, if we could get Miss Powers and Johnny Finch to join us, please.

Good morning. On behalf of the committee let me welcome each of our panelists here this morning, and as soon as you are comfortably situated, Miss Powers, we will hear from you first.

STATEMENT OF LINDA F. POWERS, DEPUTY ASSISTANT SECRETARY FOR SERVICES, U.S. DEPARTMENT OF COMMERCE

Ms. Powers. Thank you, and good morning, Mr. Chairman and members of the committee. I am Linda Powers, Deputy Assistant Secretary of Commerce for Services—Service Industries.

I am pleased to be here this morning to talk about the insurance chapter of the Industrial Outlook and about the views that the Commerce Department has expressed in that chapter about the financial condition of the insurance industry. I have attached a copy of that chapter to my written testimony and then I will add some additional remarks about issues of insurance solvency in general.

First of all, I would like to start by making a few comments about what the Industrial Outlook is, and I hope that this will put into perspective or into context the specific views that are expressed in the insurance chapter of the Outlook.

The Outlook is a publication that has been put out by the Commerce Department for 32 years. It covers in the most recent version—the 1991 Outlook covers 350 industries in 52 chapters. It is intended as a reference tool, a general reference source for researchers, for people in the industry, and every Member of Congress also receives a copy.

What the Outlook does is to highlight current developments in each of these industries that it covers and to project that industry's activities for the next year and for the longer term. It is not intended as a comprehensive or exhaustive analysis of the industry. It directs readers to other reference sources for more in-depth or detailed information.

It is also not a forum for debating or resolving policy issues, albeit that there may be very, very important policy issues affecting a given industry at a given time. Instead, what the Outlook does in its assessments of where the industry stands, in its descriptions of key developments affecting the industry, is that it identifies those policy issues and gives a sense of how those policy issues may affect the industry depending on how they are resolved, but does not try to resolve them.

Some very important policy issues are identified in the insurance chapter of the 1991 Outlook. Some of these include, for example, discussion of possible reforms to the McCarran-Ferguson legislation, the issue of bank participation in the insurance industry, and concerns about the need for product liability reforms.

Turning then to what the Outlook chapter does set forth as its assessment of the condition of the insurance industry, I will start by saying that the insurance industry is in a strong position. The American insurance industry, as already mentioned, had premium income in 1989 of $453 billion. This is more than one-third of the total worldwide premium income of all insurance industry activities worldwide. Investment income was also substantial—$135 billion—and employment was very substantial—1 million in the industry—so it is a very important industry.

What I would like to do next is summarize the main statements made in the Outlook chapter on the issue of the financial soundness of the industry. For brevity, I am only going to address the bottom line assessment, but I will note that in the Outlook chapter itself there are more specific assessments and projections made on more specific items such as expected premium income growth, asset growth, the product and market areas where most growth is likely to occur, and so on.

The industry breaks down into the life and the nonlife side—that is, the property-casualty side. On the life side, the Outlook concludes that overall that side of the business is financially sound and healthy and was financially sound and healthy in 1990.

It goes on to temper this with a cautionary note. It points out that solvency issues are of significant concern on the life side of the business, particularly because of the types and amounts of investments in real estate and junk bonds, but setting this in perspective in relative terms, it makes clear that the degree of concern, the degree of threat on this solvency issue, is low compared with the property-casualty side of the business and is particularly low compared with the savings and loan industry situation.

For the longer term, some of the items pointed out as key factors that will affect the financial health and soundness of the industry include key issues such as AIDS and the claims experience that comes from that, as well as further developments on the assets side that I mentioned, the real estate and junk bonds issues in particular.

Finally, it points out pressure on financial soundness coming from increased competition both from other kinds of financial products and from foreign financial firms in the U.S. market. We think that these views remain reasonable today. They were formulated last September and we are still of the view that that side of the industry is currently sound.

Turning to the other side of the industry, the property-casualty side, the outlook chapter emphasizes that solvency concerns were the number one item in 1990 and they remain a top priority item. We pointed out the increased level of insolvencies which were noted in the opening remarks since 1984, and make reference to some of the inquiries and investigations that have already begun looking into these solvency concerns.

The bottom line assessment that is drawn on the property casualty side of the business is that there will be financial difficulties and that the incidence of these insolvencies will remain high at approximately the levels that we have seen since 1984. A variety of factors are mentioned as leading to this assessment—things like the situation on the pricing of property casualty coverages, where we are in the underwriting cycle, the unpredictable situation that has been experienced on losses, and the general state of the economy.

I would also point out, however, that the guaranty fund assessment, the State guaranty funds assessments, those funds which are drawn on to deal with these insolvencies, have increased dramatically in the last 5 years. The assessments are made on healthy companies so that a substantial pool of funds are there for dealing with the insolvencies. And we do conclude that although the insolvency levels will remain high, they will be manageable.

Let me make an overall comment, though, that these assessments, both on the life and the nonlife side of the industry are made on an overall industry basis. They are not made on the basis of individual firms. So, while we conclude that the industry overall is healthy, one cannot necessarily draw from that that any individual firm would be considered healthy.

I would like to say that the outlook does not offer any suggested policy course or any solutions for these solvency concerns. The main thrust is to identify them as key issues of concern affecting the future health of the industry. As you know, the Federal Government does not currently have any authority for regulating the industry, and speaking on behalf of the Commerce Department, we have not taken any position on the issue of proposals that have been made and are continuing to be made for changes in this regulatory structure.

Our mission at Commerce is primarily to help create and develop market opportunities for the insurance industry and to help enhance their competitiveness. And frankly, this mission stays the same regardless of whether the regulatory structure places regulatory authority at the State level or the Federal level or some mix of the two.

We are sensitive to the importance of solvency and prudential concerns. They figure prominently in our trade negotiations. I think the best example of that, a large example right now are the Uruguay Round negotiations on services. We have had a lot of inquiries about how those negotiations would effect the ability of the United States, the U.S. Congress, and the U.S. administration to take steps that they see fit to deal with solvency concerns. The bottom line is that in those negotiations great care has been taken to carve out full discretion—carve out and preserve the full existing prudential discretion of regulatory authorities. This is so that financial regulation will remain untouched by any result in those trade negotiations.

Finally, two other comments. We at Commerce are helping the Treasury Department in its study that has been requested by Senator Riegle, specifically on the financial soundness of the industry. And we have also, in a particularly specialized area, the Risk Retention Act, put forward some proposals of our own for strengthening the standards to improve the financial soundness. Thank you.

[The prepared statement of Ms. Powers follows:]

PREPARED STATEMENT OF LINDS F. POWERS

INSURANCE INSOLVENCY AND THE 1991 U.S. INDUSTRIAL OUTLOOK

Good morning Mr. Chairman and members of the Committee. I am Linda F. Powers, Deputy Assistant Secretary for Services in the International Trade Administration of the U.S. Department of Commerce. I am pleased to speak to you today about the insurance chapter of the 1991 U.S. Industrial Outlook and about the views in the chapter regarding the financial condition of the insurance industry. Attached to my written testimony is a copy of that chapter. I then have some remarks about the Administration's position on insurance solvency.

THE U.S. INDUSTRIAL OUTLOOK

First, I would like to preface my remarks by briefly explaining the purpose of the U.S. Industrial Outlook in order to put the views expressed in the Outlook into context. For 32 years, the Outlook has provided to the public one source of information on key industries in the United States. The 1991 Outlook covers 350 industries in 52 chapters. It is considered a very useful reference tool for researchers and decision makers in business and in government. Every member of Congress receives a courtesy copy each year.

The Outlook highlights current developments in an industry and projects the industry's activity for the next year and beyond. The Outlook is largely keyed to general statistical presentations and directs readers to other reference sources for deeper analysis. The Outlook also is not a forum in which policy issues, such as insurance insolvency, are debated or conclusions made. Rather, pending policy issues of major significance to an industry are identified in the highlights of current developments. Several such issues are identified in the Outlook chapter on insurance, including the McCarran-Ferguson antitrust issue, the issue of banks participating in insurance activities, and product liability concerns.

THE FINANCIAL CONDITION OF THE INSURANCE INDUSTRY AS EXPRESSED IN THE OUTLOOK

The American insurance industry in 1989 had premium income of $453 billion, representing more than a third of the total insurance premiums written worldwide. Investment income totaled $135 billion and employment exceeded one million.

I will now summarize the statements in the Outlook on the financial condition of each major sector of the insurance industry, namely the life insurance industry and the property/casualty insurance industry.

For the life industry, the Outlook concludes that: "Overall, life insurers were financially sound and healthy in 1990." But goes on to caution that: "The solvency of a few smaller companies, however, is threatened by Excess investment in questionable real estate and junk bonds. Nevertheless, the incidence and threat of insolvency in the life insurance industry remains low compared with the property-casualty industry, even more so when compared with the savings and loan industry."

While no specific forecast on insolvency was made for the life industry in 1991, the Outlook does say that, in the long term, the solvency of the industry could be affected by such issues as AIDS, weakness in real estate, and junk bonds. Also, the Outlook points out that increased competition in life insurance from other financial products and institutions and from foreign insurers will narrow profit margins.

These views, formulated last September, are reasonable. The life industry as a whole is currently sound, but there are forces that could adversely affect the financial condition of the industry in the future.

The Outlook section on the property/casualty insurance industry portrays solvency concerns as the number one issue in 1990, capturing the attention of state regulators, Federal lawmakers, and industry officials. It notes the increased level of insolvencies in 1984 and outlines an investigation by Congress and actions taken by the state regulators.

For 1991, the Outlook projects that for the P/C industry:

"Some P/C companies will experience severe financial difficulties and the incidence of insolvencies will remain high, but manageable."

To clarify this, it means that the number and severity of insolvencies will stay at about the levels we have seen since 1984, although the current situation is not beyond the ability of state regulators to control. Moreover, net guaranty fund assessment has risen dramatically over the last five (5) years.

The industry review underlying the Outlook analysis of the insurance industry focuses on the overall economic well-being of the industry, not on the financial status of individual firms. While the Outlook concludes that, overall, the industry is financially healthy, such a conclusion cannot necessarily be drawn regarding individual firms within the industry. Indeed, it is clear that the financial strength of some individual firms is a concern.

THE AUTHORITY OF THE EXECUTIVE BRANCH IS LIMITED

The Outlook does not put forth any suggested policy course or solutions for solvency problems in the insurance industry. It does, though, recognize the views of some who favor shifting from state to federal regulation.

At present, the Executive branch of the federal government does not have statutory authority or responsibility for the financial regulation of the insurance industry; nor does it have any legal liability to policyholders of failed insurance companies.

Only speaking for the Commerce Department, we have has taken no position on the question of state versus federal regulation of insurance. One of the Commerce Department's missions is to create opportunities and enhance the competitiveness of U.S. companies, including insurance firms, in international markets. This mission remains the same, regardless of whether insurance regulation resides at the state or federal level.

Of course, the Commerce Department is sensitive to the importance of solvency and prudential concerns relating to the insurance industry. Federal policies can affect the financial condition of the insurance industry, and the financial condition of the industry can, of course, affect its competitiveness and its ability to take advantage of international market opportunities.

The Department's sensitivity is reflected in our trade negotiations and trade promotion efforts. For example, in the Uruguay Round of negotiations on services, and more specifically on financial services, an overriding principle is that any signatory would have the right to keep or institute any measures necessary to protect depositors and policyholders and ensure the financial stability and soundness of their financial services market. (This is referred to as a "prudential carve-out.") Consequently, any Uruguay Round agreement in services will preserve the full ability of regulators to protect the solvency of the insurance industry. This is, we feel, a responsible approach. Liberalization can be achieved without lowering or jeopardizing standards of prudence.

THE DEPARTMENT OF THE TREASURY IS REVIEWING THE SOLVENCY OF THE INSURANCE INDUSTRY

I would also like to say that the Administration is in the process of reviewing the solvency of the insurance industry and presenting its findings and views to the Senate Banking Committee. In December, Senator Riegle asked Secretary of the Treasury Brady to study the industry and provide recommendations. Secretary Brady replied that Treasury had already begun an informal review of the insurance industry, including issues such as solvency and regulation, and that Treasury would share its findings with Congress when they become available. Given the breadth of the issues involved, it is too early to know when those results might be available. My office has discussed the review with Treasury and will be providing advice and support. This review by the Treasury should begin to provide for a studied, informed Administration position on these issues.

CONCLUSION

We find the overall health of the insurance industry—life/health and property/casualty combined—currently sound. That is not to say, however, that all individual companies are financially sound. As we all know, there have been a number of companies which have failed. The Departments's own review of the implementation and operation of the Liability Risk Retention Act revealed several instances of insurer failures which occurred for a number of reasons including regulatory inattention, mismanagement and fraud. These findings have led the Administration, in legislation sent by this Department to the Congress this month, to propose new financial standards for insurers writing purchasing group business under the Liability Risk Retention Act.

The Department of Commerce has a strong interest in the continued financial health of the insurance industry. Not only is the insurance industry itself important to the economy, but every business in the nation relies upon the availability of reliable insurance coverage to back all business endeavors.

Thank you.

Senator BRYAN. Thank you very much, Ms. Powers. Mr. Finch, we will hear from you now, sir.

STATEMENT OF JOHNNY C. FINCH, DIRECTOR FOR PLANNING AND REPORTING, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY DR. LAWRENCE D. CLUFF, ASSISTANT DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS, GENERAL ACCOUNTING OFFICE

Mr. FINCH. Thank you, Mr. Chairman. With me today is one of our assistant directors, Dr. Lawrence Cluff. Dr. Cluff is responsible for heading up the work that GAO does in the area of the insurance industry. With your permission, sir, I do have a detailed statement. I will submit it for the record and briefly summarize.

Senator BRYAN. Let me assure you that it will be made a part of the record. And we will take your edited statement here and then we will respond with some questions, Mr. Finch.

Mr. FINCH. Thank you, Mr. Chairman. We are pleased to be here today to participate in your hearings on the condition and regulation of the insurance industry. Recent events in insurance, as well as other financial industries, clearly demonstrate the importance of close oversight and proper regulation.

Insurance is an important part of American commercial and personal financial affairs. The purchase of insurance consumes a substantial amount of our income either through direct insurance outlays or through higher prices for the goods and services we buy. We have been examining some the issues related to insurance—insolvency and regulation. Our completed work to date has focused primarily on property-casualty insurance. Therefore, my remarks today will be restricted to property casualty insurance and its regulation.

You asked, Mr. Chairman, that we summarize for the committee the results of our work regarding first, parallels that exist between the financial condition of the insurance industry and the savings and loan industry, and second, issues raised about the quality of regulatory oversight of the insurance industry.

Regarding the first point, the insurance industry has not experience the magnitude of difficulties that the savings and loan industry has, and industry analysts do not believe that large numbers of companies are in eminent danger of failing. Nevertheless, we noted similarities between the causes of failures for certain firms in both industries. Among other things, failed firms that we reviewed in both industries had inadequate internal controls, high growth, inadequate loss reserves, and a regulator who was either unwilling or unable to act quickly to resolve problems.

Regarding the second point, our work on the overall quality of oversight and solvency regulation in the insurance industry has raised a number of questions about the ability of the insurance regulatory system to identify and resolve troubled and failing insurance companies. Among the more important of these concerns are first, untimely data which inhibits regulatory ability to quickly identify problems, and financial reporting requirements which are not sufficiently comprehensive to identify the risk to which companies are exposed.

Second, wide variations among the States in both the resources devoted to regulatory oversight and the authorities that regulators have to compel behavior fostering insurer solvency.

Third, incomplete regulatory coverage of the risk to insurance companies arising from their reinsurance transactions because of the extensive international character of the reinsurance market.

And fourth, the fairness of existing insurance industry guaranty fund arrangements which vary widely from State to State as well as the capacity of existing guaranty fund arrangements to adequately protect policyholders in the event of widespread company failures.

In closing, Mr. Chairman, I would like to point out that increasing competition and narrowing profit margins are being experienced across the entire financial services sector. Moreover, fraud and mismanagement have been identified as contributing to the failure of some financial institutions. To the extent these problems adversely affect insurance companies as they have some other financial firms, the insurance regulator's responsibility is to identify problem insurance companies early and resolve them with minimum harm to insurance markets, customers, and taxpayers. A failure to fulfill this regulatory responsibility was one of the factors that changed the savings and loan industry from an industry with some troubled institutions into an industry in trouble.

We have raised some issues that stand in the way of insurance regulators effectively fulfilling their responsibility to identify problems and act early. We believe these issues are important and need to be addressed to strengthen the insurance regulatory system.

This completes my prepared statement, Mr. Chairman. We are providing copies of our published reports on insurance regulation should you want them for the hearing record or other purposes. We have given copies to your staff. We can make other copies available if you wish.

[The prepared statement of Mr. Finch follows:]

PREPARED STATEMENT OF JOHNNY C. FINCH

At the Committee's request, GAO summarized the results of its work regarding (1) parallels that exist between the financial condition of the insurance industry and the savings and loan industry, and (2) issues raised about the quality of regulatory oversight of the insurance industry.

The insurance industry has not experienced the magnitude of difficulties that the savings and loan industry has, and industry analysts do not believe large numbers of companies are in imminent danger of failing. Nevertheless, GAO noted similarities between the causes of failures for certain firms in both industries. Among other things, failed firms that GAO reviewed in both industries had inadequate internal controls, high growth, inadequate loss reserves and a regulator who was either unwilling or unable to act quickly to resolve problems.

GAO's work on the overall quality of oversight and solvency regulation in the industry has raised a number of questions about the ability of the insurance regulatory system to identify and resolve troubled and failing insurance companies. Among the more important of those concerns are:

—Untimely data which inhibits regulatory ability to quickly identify problems, and financial reporting requirements which are not sufficiently comprehensive to identify the risks to which companies are exposed.

—Wide variations among the states in both the resources devoted to regulatory oversight and the authorities that regulators have to compel behavior fostering insurer solvency.

—Incomplete regulatory coverage of the risks to insurance companies arising from their reinsurance transactions because of the extensive international character of the reinsurance market.

—The fairness of existing insurance industry guaranty fund arrangements which vary widely from state to state as well as the capacity of existing guaranty fund arrangements to adequately protect policyholders in the event of widespread company failures.

GAO believes these issues warrant consideration with the objective of strengthening regulation of the insurance industry.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to participate in your hearings on the condition and regulation of the insurance industry. Recent events in the insurance as well as other financial industries clearly demonstrate the importance of close oversight and proper regulation. Insurance is an important part of American commercial and personal financial affairs. The purchase of insurance consumes a substantial amount of our income, either through direct insurance outlays, or through higher prices for the goods and services we buy. According to the Insurance Information Institute, total insurance written for all lines equaled $453 billion in 1989, the last year for which figures are available.

We have been examining issues related to insurer solvency and regulation for several years. Our completed work to date has focused primarily on property-casualty insurance. Therefore, my remarks today will address property-casualty insurance and its regulation. Our work has included an examination of the structure and operation of the property-casualty guaranty fund system, the mechanism for protecting those with insurable losses from the financial failure of insurance companies. We have also reported on the nature of reinsurance and its regulation, and on the operation and effectiveness of the Insurance Regulatory Information System (IRIS). Finally, in the first of a series of reports on insurance solvency regulation, we examined the way state insurance regulators identify troubled insurers and how they coordinate regulatory efforts.[1]

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[1] The GAO reports referred to include:(1)Insurer Failures: Property-Casualty Insurer Insolvencies and State Guaranty Funds, GAO/GGD-87-100; (2) Insurance Regulation: Problems in the State Monitoring of Property-Casualty Insurer Solvency, GAO/GGD-89-129; (3) Insurance Regulation: State Reinsurance Oversight Increased, but Problems Remain, GAO/GGD-90-82; and (4) Insurance Regulation: The Insurance Regulatory Information System Needs Improvement, GAO/GGD-91-20.

COMPARISONS BETWEEN THE INSURANCE AND SAVINGS AND LOAN INDUSTRIES

You asked us to comment on parallels between conditions in the insurance industry and those in the savings and loan industry. Much has been made in the press and other venues about the similarities between these two industries. The insurance industry has not experienced the magnitude of difficulties that the savings and loan industry has, nor, according to industry analysts, do large numbers of insurance companies appear to be in imminent danger of failure. The past decade, however, has seen a trend of increasing numbers of failing companies. Moreover, these failed companies have, on average, been larger than in prior years. There is concern in the industry and among regulators that these trends may continue.

Beyond this general concern, our work has illustrated another comparison between these two industries that is troublesome.

Specifically, there are striking similarities between the causes of failures of certain firms in both industries. We reviewed 26 thrifts with high resolution costs that failed during the 21 months preceding September 30, 1987. At the request of the Chairman of the House Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, we compared the causes of these thrift failures with the under lying causes of the failures of Transit Insurance Company and Mission Insurance Company. These two companies remain the largest and most expensive failures in the history of insurance regulation.

Neither of these samples of failed companies were large enough or selected in a way that allows generalizations about both industries. However, out of 11 characteristics linked to the failure of Transit and Mission, 10 were also found to exist at all 26 failed thrifts.[2] These included:

—Multiple regulators,

—Growth orientation and expansion of markets,

—Excessive underpricing and minimal or poor underwriting of insurance or of loans,

—Imprudent management practices,

—Extensive and complex reinsurance arrangements in excess of normal prudent business practices (comparable to loan participations at thrifts)

—Long lapses between examinations,

—Inadequate internal controls,

—Inadequate loss reserves,

Change from traditional to potentially riskier activities, and

—Outdated audit guidelines.

To this list we would now add, based on our more recent insurance work, an unwillingness or inability on the part of the regulators to act quickly to resolve problems. Just as was true in the case of the failed thrifts, insurance regulators were unable to identify and/or act in time to forestall costly failures of Miss ion and Transit.

ISSUES IN INSURANCE REGULATION AND PROBLEM COMPANY RESOLUTION

The factors related to the failure of Mission and Transit raise a number of questions about the quality of insurance industry regulation. In the remainder of my testimony I would like to discuss some of the concerns and questions that have surfaced in our work about the ability of the insurance regulatory system to identify and resolve troubled and failing companies.

POOR DATA

A necessary precondition for effective regulatory action is good information, that is, information which is accurate, complete and timely. All states currently require the majority of the insurance companies headquartered or licensed in their state to submit the annual financial statement developed by the National Association of Insurance Commissioners (NAIC). Some states also require all or some of their companies to file quarterly financial reports. The other principal source of regulatory information about companies is the financial examination. Generally state insurance department examinations of companies are required once every 3 to 5 years, although, if an insurance department suspects a problem, the date of a scheduled examination can be accelerated.

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[2] For a full discussion of this work, see "Property and CasualtyInsurance: Thrift Failures Provide Valuable Lessons," Statement of Frederick D. Wolf, Assistant Comptroller General, Accounting and Financial Management Division, U.S. General Accounting Office; Before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives, April 19, 1989, GAO/T–AFMD–89–7.

In our work to date, we found, particularly in those states that require only annual filings, that the information may not be timely since problems occurring early in a calendar year would not be reported until the annual statement was reviewed between March and May of the following year. Moreover, there has been little regulatory verification of the data self-reported by insurance companies on quarterly and annual statements. Another congressional investigation of insurance company failures found that "False and misleading financial reports have been a major contributing factor to every insolvency and problem company observed by the Subcommittee."[3]

We have no reason to doubt the general veracity of the information filed by most insurance companies with their regulators. However, we also believe it is reasonable to assume that a company in trouble would be more likely to attempt hiding its true condition from the regulator. Thus, even if most companies do report with reasonable accuracy the lack of verification of data by the regulator to determine whether information is false or inaccurate negates much of the value of the regulatory system for promptly identifying and resolving regulatory problems.

In addition to the problem of potential inaccuracies or deliberate misstatements in insurer financial reports, the general adequacy of the financial statement for identifying problems that would pose regulatory concerns may be open to question. Certain activities that insurance companies engage in and the risks associated with those activities are not captured in annual financial statements. A recent report comparing the condition of insurance and other financial industries published by the Insurance Information Institute states that "Analyzing individual companies exclusively on the basis of publicly reported data is a hazardous business. Off-balance sheet assets and obligations, which can involve activities ranging from letters of credit to merchant banking, can significantly alter values, and critical variables such as the quality of assets or the adequacy of reserves or pricing often cannot be gleaned from the data until the problem is beyond remedy."[4]

These data inadequacies are particularly troublesome since, as we recently reported, the NAIC's Insurance Regulatory Information System, used by many insurance departments as part of their early warning system for identifying solvency problems in companies operating in their states, uses annual statement data exclusively. Whatever deficiencies exist in the annual statement data, therefore, apply equally to the early warning capability of IRIS.

REGULATORY RESOURCES AND AUTHORITIES

In addition to an effective early warning system, the ability of state insurance regulators to identify problem companies and to act quickly and effectively depends on having sufficient resources and authorities. In our work, we have not identified readily available criteria for establishing how large a budget or how many staff are sufficient for effective regulation. We have, however, found that the level of resources available to state insurance departments varies dramatically from state to state. For example, in the five states that we visited while preparing our September 1989 report on insurance regulation, the ratio of annual statements submitted by insurance companies operating in the state to the number of reviewers assigned to analyze those statements in 1988 varied from 79 annual statements to 1 reviewer in Connecticut to 792 to 1 in Arizona.

Besides sufficient staff and other resources, state insurance regulators need the legal and regulatory tools to allow them to effectively deal with problem insurers. NAIC develops and adopts model laws and regulations that state insurance commissioners collectively feel are necessary to regulate the business of insurance. However, NAIC has no authority to require individual states to accept and codify the models. As a result, substantial differences exist in the regulatory tools used by the various state insurance departments, and in the scope of their authority. These differences translate directly into differences in the quality of regulation in the various states.

In its new program for certifying state insurance departments, NAIC has established minimum financial regulation standards, including specific laws and regulations that states should have in place. Since the certification program was adopted in June 1990, two states—Florida and New York—have been certified. We do not know how many other states will meet the minimum standards, but it is widely believed that many states will have to adopt or amend a number of laws in order to become certified.

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[3] Failed Promises: Insurance Company Insolvencies, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives; February, 1990; page 70.

[4] Rating The Risks: Assessing the Solvency Threat in the Financial Services Industry, by Orin Kramer, Insurance Information Institute, 1991, page 7.

REINSURANCE

Reinsurance is insurance for insurance companies. Insurers spread the risks they accept by buying reinsurance. This mechanism is important to the availability of insurance and to the financial stability of the insurance system. However, uncollectible reinsurance has, itself, contributed to solvency problems for some insurers. Even though the primary insurer can, for payment of a fee, pass some of its risk of loss on to a reinsurer, the primary insurer remains liable to pay all claims resulting from the business it originally insured. If the reinsurer, for any reason, is unable or unwilling to reimburse its share of the primary insurer's outlay, the result may be a significant financial loss for the primary insurer.

Regulatory coverage of the reinsurance market is incomplete because of its international character. Although many reinsurance companies are licensed or headquartered and therefore regulated in the United States, non-US. companies provide about one-third of the reinsurance coverage in the U.S. market. However, state insurance regulators have neither the authority to regulate nor the ability to effectively monitor the financial condition of non-U.S. reinsurers. Therefore, regulators are unable to assess the vulnerability of U.S. primary insurers to the risks from purchasing reinsurance from non-U.S. reinsurers. Existing regulatory mechanisms to require security for these transactions have also proven inadequate.

GUARANTY FUNDS

Every state has a guaranty fund to pay claims when a property-casualty insurer fails. Most states have guaranty funds for failed life and health insurers. The mechanism of these funds is generally similar. When an insurance company fails, the future cost of paying claims is estimated and each state's guaranty fund assesses surviving companies a percentage of their in-state insurance activity (usually 1 to 2 percent) to pay the claims as they are reported. The assessed companies can then, depending on the state, either reduce their state tax liabilities or increase their premium rates to offset the assessments. In effect, the assessment mechanism passes the cost of insolvencies on to policyholders through premium increases or to taxpayers through state tax offsets.

There are two interesting questions related to the insurance guaranty funds. The first is a question of fairness. Every fund has payment caps and eligibility rules for payment of claims against failed companies. Because these caps and rules vary from state to state, two claimants with the same insurance coverage and identical losses in two different states may well receive different payments from their respective guaranty funds.

The second question involves the capacity of the system. The existing guaranty fund system was designed in an era when insurer failures were infrequent and relatively small in size. In addition, all funds have limits on how much an insurer can be assessed in a single year. These limits also vary from state to state. If trends toward, increased size and frequency of failures seen in recent years continue, coupled with assessment limits, claims on the funds in some states may exceed their capacity to pay. Although the guaranty funds are designed so that the industry initially pays for the costs of failed companies, in the event of widespread guaranty fund capacity problems a potential liability for the states may exist.

SUMMARY

Increasing competition and narrowing profit margins are being experienced across the entire financial services sector. Moreover, fraud and mismanagement have been identified as contributing to the failure of some financial institutions. To the extent these problems adversely affect insurance companies as they have some other financial firms, the insurance regulator's responsibility is to identify problem insurance companies early and resolve them with minimum harm to insurance markets, customers, and taxpayers. A failure to fulfill this regulatory responsibility was one of the factors that changed the savings and loan industry from an industry with some troubled institutions into an industry in trouble.

We have raised some issues that stand in the way of insurance regulators effectively fulfilling their responsibility to identify problems and act early. We believe these issues are important and need to be addressed to strengthen the insurance regulatory system.

This completes my prepared statement. We are providing copies of our published reports on insurance regulation should you want them for the hearing record or other purposes. We would be pleased to respond to your questions.

Senator **Bryan**. Thank you very much. We have been joined this morning by the senior member of the Commerce Committee, Senator Exon. Senator, let me yield for you for any opening comment you would care to make.

OPENING STATEMENT BY SENATOR EXON

Senator **Exon**. Mr. Chairman, thank you very much. And I very much appreciate your calling this hearing. As one who has been a student of, and generally supporter of the insurance industry in total for many, many years, I think it is a timely matter indeed that we are addressing here today. And I appreciate the excellent group of witnesses that you have summoned to this particular hearing. I have nothing further to say at this time except that I am delighted to see the large attendance in the room this morning which indicates to me that the insurance industry is recognizing the responsibility that the industry as a whole has toward looking at what might be even a more serious problem on down the line.

Certainly the Congress as a whole with the experience that we have had with the S&L's and now fairly concerned about certain sectors of the banking industry itself—it is not unusual, therefore, that in representing the overall consumer and the public good, the Congress is very much concerned about the insurance industry as a whole.

Having said that, it is my conviction from the studies that I have made of this matter that the industry as a whole faces nothing at all similar to what we found in the S&L proposition. There are significant differences that in the S&L's and the banks the Government had guarantees that they perform, we have none of this in the Federal Government as such with regard to the insurance industry. But looking at the overall health of the economy of the United States of which the insurance industry plays such a significant role, it is indeed proper that we meet such as we are meeting here for an oversight hearing to have you, experts in the field, give us your views on what we should and what we should not do.

I am aware of the fact that there may be bills introduced in the House of Representatives. There is talk of legislation being introduced on the Senate side with regard to significant changes in the Federal Government's role in the insurance industry. I look at those initiatives with a very suspect eye, since it is evident to me that the Government as a whole, the Federal Government, has not functioned very well with regard to the collapse of the S&L industry and possible difficulties that we are facing now in the banking industry. And therefore, I am quite suspect of the fact that we think that the Federal Government rules and regulations are going to be the panacea to make sure that the insurance industry itself does not have similar difficulties.

So, I suffice to say, at least at this time, I am led to believe that the insurance industry is nowhere near the financial difficulties we have seen in other sectors of the financial structures of the United States. But that does not mean, Mr. Chairman, that we are not very much concerned. And my thinking is that we should be working constructively with the insurance industry.

And although I have noticed in the last year or two from various sources that there is indeed some disagreement within the insurance industry itself with regard to what should or should not be done. There was a time when the insurance industry was almost united behind the fact that the Mccarran-Ferguson Act should indeed remain the posture of the industry. Some fainthearted souls in the industry, in my view, have been thinking well, maybe that would not be too bad an idea if the Federal Government did get involved.

I simply say to you that the Federal Government is not in the financial position to begin any kind of a thought process with regard to guarantees to the insurance industry. We have got our hands full the way it is. So, I would hope and caution against any hasty action in this regard. And nevertheless we would be putting on blindfolds if we did not recognize that there are some potential problems in the insurance industry as a whole, primarily as I understand it, in some of the casualty companies and some of the health and accident insurance companies. Well, as near as I can tell, if they are all well run, the life insurance companies are in no immediate trouble.

Thank you, Mr. Chairman.

Senator BRYAN. Thank you very much, Senator Exon.

Senator Kasten.

OPENING STATEMENT OF SENATOR KASTEN

Senator KASTEN. Thank you, Mr. Chairman, for calling this hearing on whether or not one more area of financial services may be heading towards a weakness which would be devastating and piled on top of the savings and loan debacle. We are just now trying to figure out how the American public will pay for the problems in that area.

I look forward to the testimony of our witnesses from Government and academia today as they present their views on whether or not there is even a problem in the insurance area.

It appears to me that while there may be isolated areas of concern, such as accounting practices, that overall the industry is healthy and is not on the road to the problems which we face with savings and loans and commercial banks.

Again, thank you for holding this timely hearing. The House has already begun a look into this problem in the Energy and Commerce Committee and it is only wise that we educate ourselves in this area.

Senator BRYAN. Thank you, Senator Kasten.

Maybe I will begin with you, Ms. Powers with a question, if I may. You indicated that you are responding to a request from Senator Riegle to do an overall review on solvency. And my first question is, How far along are you in that review? When do you expect that report to be available?

Ms. POWERS. The primary responsibility for that rests with the Treasury who was the recipient in the request. We are working with them. It is in the very beginning stages. It began a couple of weeks ago. And it is too early to tell how long it will take. It is very comprehensive. It is going to take—we will be working on that all year.

Senator BRYAN. OK. So, we should not expect to see that until sometime next year, then I gather from your statement. You made a comment in your conclusion that dealt with the Liability Risk Retention Act and proposed legislation in terms of standards. To what extent do you think that the Liability Risk Retention Act created any of the problems which you have discussed somewhat generally in your overall observation? In other words, How big a problem is it as you perceive it?

Ms. POWERS. Well, let me give a limited answer. While coming from the International Trade Administration, I do not have the actual authority for that area. It rests with the Economic and Statistics Affairs Administration.

But to give you a brief answer on that, the Commerce Department undertook a review of the situation in which the risk retention pools and the purchasing groups were operating under the act. They found some weaknesses in the system as it was operating. And that was a sufficient level of concern to warrant proposing higher standards. So, that is a step we have taken. I would not like to say what the cause of the—you know, ascribe it to the legislation or whatever, but just to say that we saw a problem and have tried to propose a solution.

Senator BRYAN. Can you give us some sense as to the extent of foreign penetration into the American insurance market, give us some trend lines? Some of the data that has been submitted to the committee would indicate that there has been a substantial growth in recent years. Can you put that into some perspective for us?

Ms. POWERS. Well, foreign insurers are moving into the U.S. market at a faster rate than U.S. insurers are moving into foreign markets. We are, in the Commerce Department, spending a lot of time and effort to help our companies as much as possible to increase the rate at which we are moving into foreign markets. To put that into sort of percentage terms, on the life side, it is about 5.9—or 5 or 6 percent of the U.S. market is held by foreign insurers. On the property casualty side, it is much higher. It is in the neighborhood of 13 percent. So that the combined overall is in the neighborhood of the high, 9.8 to 10 percent, thereabouts.

I would point out that in Japan, for example, the collective market share of all foreign insurers has been static at about 3 percent, collectively for about 10 years. In Europe we are doing a little better. Some of the 1992 things have opened up new opportunities there. It varies.

Senator BRYAN. A broader question, if I may, and that is, can you share with the committee what is the profitability—that is a different question, I realize, than the insolvency issue, which has been the primary focus this morning, but can you share with us what the profitability is of the American insurance industry, both the property and casualty and life-health lines?

Ms. POWERS. I can speak in relative terms. I cannot give you specific detailed percentages.

Senator BRYAN. No, I understand that.

Ms. POWERS. The profitability is substantially better on the life side. On the property casualty side, on the underwriting side of the business as opposed to the investment side of the business, things are pretty bad.

We projected, for example in our Outlook chapter, a 30-percent increase in underwriting losses for this year. The reason for that is the squeeze that comes from several factors: the factor of soft pricing due to excess capacity, and the fact that the loss experience has been beyond what was expected and it is unpredictable. So, you put those two together, coupled with the general state of the economy, and you have got a squeeze. And then you add on top of that the squeeze from increasing foreign participation, which as I said was heavier on that side of the business, and you have got a real squeeze.

Senator BRYAN. You point out that there are wide variations in the quality of regulation among the respective States.

Does that suggest to you any actions that need to be taken, either at the Federal, the State level?

Mr. FINCH. Well, sir, I think to the extent that you have variability, certainly there is opportunity to create greater certainty and more fairness in a system. So, I think, yes, I think there is the opportunity to get better uniformity among the States.

Senator BRYAN. And how do we do that?

Mr. FINCH. I think that is an unanswered issue, Mr. Chairman. I do not have the answer to that question. I think we have raised some issues, and I think others have raised issues that deal with that central question.

And I think these issues need to be addressed. I do not think answers are yet available. I think this hearing is a very positive step in reaching out for answers.

Senator BRYAN. Mr. Finch, as you may have noted from our witness list, our third panel will have a representative of the NAIC. They have, of late, talked a good bit about their certification process in which they are trying to improve the quality of regulation among the insurance commissioners.

Do you have a sense as to how effective that has been or how effective it can be?

Mr. FINCH. No, sir. We do not really. The certification process has only recently been put into place, I think June 1990. Since that time there have been only two States, Florida and I think New York, that have been certified.

So, it is a bit early yet to tell. We do think the certification process is a step in the right direction, though.

Senator BRYAN. Another point you make in your testimony is poor data. That is, I believe to paraphrase, that you believe that essentially the system by which annual filings are required, and which is used by State regulators to monitor the financial solvency of companies is hampered by the use of untimely data.

That is, at the beginning of the filing period things might be very good, but some marked deterioration may occur during the course of that year.

Is your concern shared by State insurance regulators?

Mr. FINCH. I think so, sir. I think so, and I think there have been some lessons in the S&L situation that have passed along in that regard. And one is that you do need current and accurate financial data. You need data that includes also information other than pure financial activities.

You need some information that gets into the operational activities and some information which gives you an indication of management's performance.

Senator BRYAN. What actions do you see, if any, being undertaken at the State level with respect to this specific concern; namely, the timeliness of data to rely upon?

Mr. FINCH. We issued a report recently which dealt with this in the context of the IRIS system. And we encouraged NAIC to take the lead in working with the States to try to get more current and more complete data.

That recommendation was fairly recent, and I am not quite sure what actions they have taken in terms of implementation. Let me turn to my colleague here.

Mr. CLUFF. NAIC developed a quarterly statement some time ago and has been encouraging States to begin to use it. A number of States have begun to do so, either for all or part of their companies.

Our sense is that that quarterly data is not completely integrated into the regulatory system as yet, although I think there is certainly a recognition by the NAIC and by some of the States that annual data is probably inadequate.

Senator BRYAN. Thank you very much. I note my time has expired.

Let me yield to Senator Gorton, who joins us for an opening statement before returning to Senator Exon for a round of questions.

Senator GORTON. Why do you not go to the Senator first?

Senator BRYAN. Let me yield to you.

Senator EXON. Thank you. I would like to begin by quoting from two recent resolutions that I will be offering in a few moments to be made part of the record.

They are on behalf of the National Governors' Association and the National Conference of State Legislators, neither of those groups are represented by witnesses here this morning. They have asked me to introduce, on their behalf, statements in this regard by these two very prominent associations.

Senator Bryan and I and the Governors were very important contributors to the National Governors' Association. I quote, I think a key line from the National Governors' Association in this regard, and it is entitled, "Proposed Committee Resolutions, State Regulation of Insurance."

And it says, "The committee reaffirms existing National Governors' Association's policy stating opposition to Federal preemption of State regulation of the insurance industry," and further states as follows.

And then referring, if I might for just a moment to the National Conference of State Legislators, the key operative phrase here it seems to me is, "A third important reason for State action as soon as possible is to provide an alternative for Federal intervention. Some consumer advocates and insurance executives already are calling for Federal legislation that would preempt State authority. Additionally, there is a concern that such Federal action could lead to Federal preemption of States' insurance premium tax base."

It goes on. Mr. Chairman, at this time, I would like to offer these two statements and ask that it be made part of the record at this point.

Senator BRYAN. The statements will be made a part of the record.

[The material referred to follows:]

PREPARED STATEMENT ON INSURANCE COMPANY INSOLVENCIES

The safety and soundness of insurance companies operating in the United States is a prime objective of state insurance regulation. To ensure that this objective is met, an effective financial surveillance and regulation system is needed. This will require immediate state action to strengthen state insurance departments and to create standards for financial regulation that will strengthen the safety and soundness of insurance companies.

First of all, state insurance regulation must be strengthened in order to protect policyholders. The public depends on solvent insurance companies to provide retirement income, income protection in case of death or disability, protection from catastrophic loss, and safe investment opportunities.

Second, solvency regulation must be improved in order to protect state treasuries. When an insurance company fails, healthy companies are assessed to pay off policyholders. Many states allow such assessments, under state guaranty fund systems, to be offset against state premium taxes. In addition, some state pension funds and a few bond issuers have purchased guaranteed investment contracts that depend on the solvency of life insurance companies. Finally, if state guaranty fund systems were to collapse under the weight of too many insolvencies, some moral obligation on the state to protect policyholders might be alleged.

A third important reason for state action, as soon as possible, is to provide an alternative to federal intervention. Some consumer advocates and insurance executives already are calling for federal legislation that would preempt state authority. Additionally, there is a concern that such federal action could lead to federal preemption of the states' insurance premium tax base. We believe there are many advantages to state regulatory authority, including staff expertise that has developed over man years. The National Conference of State Legislatures (NCSL) believes that a heavy burden of proof must be met before federal intervention and preemption are justified. The NCSL recognizes that swift and effective action by state legislatures to reform state solvency regulation will serve to deter any unjustified federal preemption.

Improving state regulation of insurance for solvency will require attention (1) to laws and regulations, (2) regulatory practices and procedures, and (3) to the possible need for additional resources, expertise and state legislative oversight to ensure their effective implementation. In order to achieve these goals, NCSL recommends adoption of the model laws and regulations developed by the National Association of Insurance Commissioners (NAIC), as summarized below in A and B.

A. LAWS AND REGULATIONS

1. *Examination Authority:* Each insurance department should have adequate authority to examine the finances of insurance companies whenever it is deemed necessary.
2. *Capital and Surplus Requirements:* State law should require that insurers have and maintain a minimum level of capital and surplus to transact business. State law should require additional capita and surplus based upon the type, volume and nature of insurance business transacted.
3. *Accounting Practices and Procedures:* Each insurance department should require that all companies adopt appropriate accounting practices and procedures.
4. *Corrective Action:* State law should provide sufficient authority for the state insurance department to order a company to take necessary corrective action when it is deemed to be in hazardous financial condition or to cease and desist in certain practices which, if not corrected, could place the company in a hazardous financial condition.
5. *Valuation of Investments:* Each department should require that securities and other invested assets owned by insurance companies be valued in accordance with recognized standards.
6. *Holding Company Systems:* State statute should provide for the proper regulation of insurance holding companies.
7. *Risk Limitation:* State statute and regulation should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk, based upon the company's capital and surplus.
8. *Investment Regulations:* State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity. Foreign companies should be required to substantially comply with these provisions.

9. *Admitted Assets:* State statute should describe those assets which may be admitted, authorized or allowed as assets in the statutory financial statement of insurers.

10. *Liabilities and Reserves:* State statute should prescribe minimum standards for the establishment of liabilities and reserves resulting from insurance contracts issued by an insurer.

11. *Reinsurance Ceded:* State statute should provide for regulation of credit for reinsurance and reinsurance agreements.

12. *CPA Audits:* State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants.

13. *Actuarial Opinion:* State statute or regulation should contain a requirement for an opinion on life and health policy claim reserves and loss, and loss adjustment expense reserves of property and casualty companies by a qualified actuary or specialist on an annual basis for all domestic insurance companies.

14. *Receivership:* State statute should set forth a receivership mechanism for the administration, by the insurance commissioner, of insurance companies found to be insolvent.

15. *Guaranty Funds:* State statute should ensure the payment of policyholder obligations subject to appropriate restrictions and limitations when a company is deemed insolvent.

16. *Regulation of Managing General Agents:* State statute should provide for regulation of managing general agents.

17. *Regulation of Reinsurance Intermediaries:* State statute should provide for regulation of reinsurance intermediaries.

18. *Regulation Information:* State statute should require domestic insurance companies to participate in the NAIC Insurance Regulatory Information System (IRIS).

19. *Risk Retention Groups:* State statute should provide appropriately for the regulation of risk retention groups and purchasing groups.

20. *Producer Controlled Insurers:* State statute should provide for regulation of business transacted with a producer controlled property/casualty insurer.

B. REGULATORY PRACTICES AND PROCEDURES

1. *Financial Analysis:* Each state insurance department should have a sufficient staff of financial analysts with the capacity to effectively review the financial statements as well as other information and data to discern potential and actual financial problems of domestic insurance companies.

2. *Examinations:* Each state insurance department should have the resources to regularly examine all domestic companies.

3. *Professionalism:* Each department's examination staff should consist of a variety of specialists with the training and/or experience that will allow for the effective examination of any insurer.

4. *Priority Examinations:* In scheduling financial examinations, each department should accord priority to companies that are experiencing adverse financial circumstances.

5. *Interstate Communication:* When a domestic company is identified as troubled, this should be communicated to other insurance departments in jurisdictions in which the carrier transacts business. When a foreign company is identified as troubled, this should be communicated to the domiciliary insurance department of the carrier.

The standards set forth in sections A and B are submitted as minimum requirements for the effective regulation by a state of the financial solvency of those insurance companies doing business within that state. Each state should consider whether the enactment of additional safeguards beyond these minimum requirements would be appropriate for that jurisdiction

For most states, the enactment and implementation of the standards set forth herein will entail additional expense. To determine the precise needs in furthering the goals stated herein, state legislatures and regulators could embark on a thorough review of existing resources, management operations, and policy implementation procedures. State legislatures could exercise appropriate oversight of their insurance departments through their standing committees and budget process, and through performance, management and compliance audits. In order to obtain necessary funding without further burden to taxpayers, states could consider the imposition of a special assessment on insurance companies doing business within the state in order to defray the increased cost of regulation.

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Insurance

Premium receipts of life insurance companies will increase 8 percent in 1991, with annuities leading the way. Premiums written by property-casualty insurers will grow 6.2 percent. Despite small commercial rate increases, large underwriting losses will reduce earnings in the property-casualty industry and insolvencies will remain at a high level.

LIFE INSURANCE

Premium receipts of life insurance companies increased 8.8 percent in 1990, to $265.9 billion, the result mainly of continued strong sales of annuity and health insurance contracts and a renewed consumer interest in life products. Measured by face value, sales of life insurance increased 4 percent. Life insurance companies' assets increased 10.2 percent, to $1.4 billion, while employment remained stable at 576,300.

The life insurance industry consists of companies that underwrite life insurance and annuities; they also underwrite accident and health insurance and manage pension and trust funds. The companies are classified in SIC 631 (Life Insurance) or in SIC 632 (Accident and Health Insurance). Stock companies, which are owned by shareholders, and mutual companies, which are owned by policyholders, constitute the two main types of insurance providers. Although almost 95 percent of insurance providers are stock companies, mutual companies accounted for about 45 percent of the industry's total assets and 36 percent of the total premiums received in 1989.

Income of Life Insurance Companies

Life insurers derive their premium income from three major types of products: life insurance, annuities, and health insurance. Premium income from life insurance products dropped slightly in 1989 (Table 1). In a turnaround, however, a midyear 1990 survey showed that sales of term insurance, variable, variable universal, and whole life grew significantly over 1989. Only sales of universal life policies decreased. Sales of single-premium policies remained flat in 1990. Traditional whole-life policies made up more than half of individual life insurance sales, while universal policies accounted for another quarter. Premium income from group life, which made up 20.6 percent of all life insurance premiums in 1989, was expected to have gone up again in 1990, but to have diminished as a percentage of sales.

Table 1: U.S. Life Insurance Company Income Selected Years, 1970–1989

(in billions of dollars)

Source	1970	1980	1986	1987	1988	1989
Total income	49.1	130.9	282.3	314.3	338.1	367.3
Total premium receipts	36.8	92.6	194.1	213.0	229.1	244.4
Life insurance premiums	21.7	40.8	66.2	76.7	73.5	73.3
Annuity considerations	3.7	22.4	83.7	88.7	103.3	115.0
Health insurance premiums	11.4	29.4	44.2	47.5	52.3	56.1
Investment income	10.1	33.9	75.4	82.9	92.0	104.0
Other income	2.1	4.3	12.7	18.5	17.0	19.0

NOTE: Totals may not add up due to rounding.
SOURCE: American Council of Life Insurance.

Term life insurance is pure protection, whereas whole life consists of insurance and savings components. A whole-life policy builds value that can be cashed in or borrowed against. Universal policies are variations of whole life that enable a policyholder to adjust premium payments and death benefits. Another type of whole life is variable life; its death benefit and cash value depend on the value of the underlying assets, such as stocks, that back the policy.

Individual and group annuities accounted for the largest portion and had the highest rate of growth of all components of life insurance companies' premium receipts in 1989. There was a particularly strong increase in sales of

Trends and Forecasts: Life Insurance

(in billions of dollars except as noted)

Item	1987	1988	1989	1990[1]	1991[2]	Percent Change 1987-88	1988-89	1989-90	1990-91
Premium receipts	213.0	229.1	244.4	265.9	287.2	7.6	6.7	8.8	8.0
New life insurance purchases[3]	1,352.5	1,408.9	1,441.7	1,499.4	1,558.4	4.0	2.5	4.0	3.8
Life insurance in force[3]	7,452.5	8,020.2	8,694.0	9,478.5	10,357.8	7.6	8.4	9.0	9.3
Total benefits paid	71.6	74.1	80.2	84.2	88.8	3.5	8.2	5.0	5.5
Life insurance assets	1,044.5	1,166.9	1,299.8	1,432.4	1,572.8	11.7	11.4	10.2	9.8
Employment (SIC 6311)[4]	578.1	576.5	576.2	576.3	577.0	-0.3	-0.1		0.1

[1] Estimate.
[2] Forecast.
[3] Excludes foreign business.
[4] Employees on payroll only.

SOURCE: American Council of Life Insurance; U.S. Department of Labor, Bureau of Labor Statistics. Estimates and forecasts by the U.S. Department of Commerce, International Trade Administration.

individual variable annuities and annuities that qualify for certain tax benefits, such as deferrals and credits. Like variable life insurance, the value of variable annuities depends on their underlying assets. Tax-advantaged annuities include Individual Retirement Accounts (IRAs) and 401(k) salary deduction plans.

Life insurance companies are major providers of group annuities for employer-provided pension plans. Two-thirds of annuity sales come from group annuities, which had solid increases in 1989.

Premium receipts from health insurance grew in 1989. Group health policies, which are generally provided through employers, constituted about 75 percent of the $56.1 billion in health premiums that life insurers received in 1989. The percentage is diluted by the increasing proportion of group health contracts that are provided only as administrative services, under which the insurer does not assume the full risk for future claims.

Assets of Life Insurance Companies

The assets of life insurance companies consist mainly of financial instruments. These assets back insurance and annuity reserves that are legally required to pay future claims and to provide the necessary surplus and capital to meet solvency standards. This makes life insurance companies major institutional investors. Of total assets, corporate securities accounted for 51.1 percent at the end of 1989 (Table 2). Bonds have made up a significantly higher share since 1986. Policy loans as a percentage of assets decreased considerably, from 5.8 percent in 1986 to 4.4 percent in 1989. Government securities also became less significant as a component of assets. The proportion of real estate, mortgages, and other assets decreased slightly.

Table 2: Life Insurance Company Assets, 1986 and 1989

Type of Asset	1986		1989	
	Billions of dollars	Percent of total	Billions of dollars	Percent of total
TOTAL	937.6	100.0	1,299.8	100.0
Corporate securities	432.8	46.2	663.7	51.1
Bonds	342.0	36.5	538.1	41.4
Stocks	90.9	9.7	125.6	9.7
Mortgages	193.8	20.6	254.2	19.5
Policy loans	54.1	5.8	57.4	4.4
Government securities	144.6	15.4	178.1	13.7
Real estate	31.6	3.4	39.9	3.1
Miscellaneous	80.6	8.6	106.4	8.2

NOTE: Totals may not add up due to rounding.
SOURCE: American Council of Life Insurance.

Overall, life insurers were financially sound and healthy in 1990. Operating revenues were up, while operating and administrative expenses remained under control. Investment income was solid. The solvency of a few smaller companies, however, is threatened by excess investment in questionable real estate and junk bonds. Nevertheless, the incidence and threat of insolvency in the life insurance industry remains low compared with the property-casualty industry, and even more so when compared with the savings and loan industry.

Key Legislative and Regulatory Developments

The taxation of life insurance companies and their products are perennial issues at state and Federal levels, particularly as pressure grows to find new sources of revenue. Under consideration are changes that would equalize the relative amount of taxes paid by mutual and stock companies. Other proposals include limiting the deductibility of policyholder dividends, thus raising taxes on mutual companies, and basing taxes on specifically defined alternative measures of income, rather than on statutory income, as is the current practice.

Another issue is the taxation of interest income in insurance and annuity products (referred to as "inside build-up"), now subject to deferral or exemption, and the deferral of policy acquisition costs over a number of years. In addition, policymakers are debating whether to exempt from taxation premature distributions of death benefits to policyholders with terminal illnesses.

The McCarran-Ferguson Act of 1945, which left regulation of insurance companies to the states and exempts the industry from certain aspects of Federal antitrust law, forms the basic regulatory and economic framework of the industry. In 1990, for the first time ever, a bill to repeal the antitrust provisions of McCarran-Ferguson was approved by a committee in the House of Representatives. The insurance industry opposes repealing the law, which allows joint underwriting and data sharing. But a revision or repeal of McCarran-Ferguson is considered inevitable by many observers.

Another long-standing issue is the entry of banks into insurance. The industry argues that separation of powers between banking, securities, and insurance provides stability in the market and protects consumers. But proponents of greater integration of financial services argue that it would promote economic efficiency. Many states already allow state banks to sell and/or underwrite insurance. Delaware passed a law in 1990 that would have allowed state-chartered banks, even those owned by bank holding companies, to sell and underwrite insurance in any other state. But a ruling by the Federal Reserve Board in effect nullified the law.

One of the most critical issues that affects the life insurance industry is the Government response to an estimated 30 million Americans who have no health insurance. Another major problem is the long-term effect of AIDS on the industry.

INTERNATIONAL COMPETITIVENESS

As financial markets have become more global, U.S. life insurers have set up foreign branches, subsidiaries, and joint ventures. In addition to underwriting life, health, and pension products, the companies provide such auxiliary services as claims processing, investment services, and information systems. Insurers also have been active in some banking and securities markets overseas, where there are no restrictions separating such activities similar to those in the United States.

Japan, where life insurance is a preferred means of saving, had the largest life insurance market (excluding health insurance) in 1988, with $214.1 billion in premiums (Table 3). The United States was a close second, and the United Kingdom a distant third.

The extent of U.S. participation in life insurance markets around the world is reflected in Table 4. Foreign life

Table 3: World Insurance Markets[1] 1988 Premiums

(in billions of dollars)

Item	Total	Life	Nonlife[2]
Total, all countries	1,171.0	615.9	555.1
United States	431.4	176.8	254.6
Canada	26.5	12.8	13.8
Europe	349.0	169.3	179.8
West Germany	79.3	36.6	42.7
United Kingdom	69.0	40.9	28.1
France	52.2	25.5	26.6
Italy	20.0	4.8	15.2
Switzerland	15.1	8.7	6.5
Netherlands	15.1	7.3	7.8
Other	98.4	45.5	52.9
Asia	322.7	237.6	85.1
Japan	284.6	214.1	70.5
South Korea	16.5	13.7	2.8
Taiwan	4.6	3.2	1.4
Other	17.0	6.6	10.4
Latin America	8.6	1.8	6.8
Africa	12.4	7.2	5.2
Oceania[3]	20.4	10.5	9.9

[1] Includes centrally planned economies as well.

[2] Nonlife business includes accident and health insurance as well as property/casualty insurance.

[3] Includes Australia, New Zealand, and South Pacific Islands.

NOTE: Detail may not add to totals due to rounding.

SOURCE: *Sigma*, May 1990, Swiss Reinsurance Company.

insurance affiliates (branches and subsidiaries) of U.S. companies had more than $9 billion of sales (premium plus investment plus other income) in 1988. Although foreign sales of U.S. companies are small compared with the vast domestic market, foreign life insurance markets are growing faster. Canada, Europe, and Japan have been key markets for U.S.-owned life insurers (Table 5), and recently they have made significant entries into Korea, Taiwan, and other growing Asian markets.

Foreign insurance companies have greatly expanded their activities in the United States over the past few years, mainly through acquisitions, and in 1988 they accounted for an estimated 5.9 percent of total life insurance premiums. For all lines of insurance, foreign-owned companies operating in the United States received about 9.3 percent, or $40 billion, of total premiums in 1988.

Table 4: Foreign Insurance Affiliates[1] of Nonbank U.S. Parents

Item	1983	1985	1987	1988[2]
All insurance				
Number of affiliates	621	617	631	641
Total assets (mil. $)	46,896	56,381	80,353	86,025
Sales (mil. $)[3]	16,273	17,860	26,949	27,822
Life insurance				
Number of affiliates	88	87	86	89
Total assets (mil. $)	19,655	21,310	28,629	30,517
Sales (mil. $)[3]	5,913	5,622	7,794	9,036
Accident and health insurance				
Number of affiliates	34	34	39	39
Total assets (mil. $)	2,181	3,044	6,252	7,272
Sales (mil. $)[3]	856	1,046	2,119	2,570
Other insurance				
Number of affiliates	499	496	506	513
Total assets (mil. $)	25,060	32,027	45,472	48,236
Sales (mil. $)[3]	9,503	11,192	17,037	16,216

[1] Affiliates include entities at least 10 percent owned by a U.S. person.

[2] Preliminary estimates.

[3] Sales equals premium income plus investment income plus other income.

NOTE: Detail may not add to totals due to rounding.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad*, various issues.

Table 5: Sales[1] by Foreign-Owned Insurance Affiliates, 1988

(in millions of dollars)

Country of Parent[2] Country of Sales	Foreign-owned Affiliates in the U.S.	U.S.-owned Affiliates Abroad
All countries	49,292	27,822
Canada	11,321	6,415
Europe	27,541	10,137
Switzerland	4,286	NA
European Community	22,484	NA
Netherlands	10,386	NA
United Kingdom	9,628	NA
West Germany	2,029	NA
Other	441	
Other	771	
Latin America[3]	311	5,157
Japan	300	4,146
Australia	613	NA
Other countries[4]	9,206	NA

NA: Not available.

[1] Sales equals premium plus investment plus other income for insurance affiliates that are 10 percent or more owned by any one foreign person.

[2] Country of ultimate beneficial owner (UBO).

[3] Includes offshore centers such as Bermuda and the Bahamas.

[4] Includes the United States as a UBO.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, Preliminary 1988 Estimates*, Table E-4, August 1990, and *U.S. Direct Investment Abroad, Preliminary 1988 Estimates*, Table 7, July 1990.

The U.S. life insurance affiliates of non-U.S. parents had sales of about $19.9 billion in 1988, up from $16.8 billion in 1987 (Table 6). These affiliates controlled about $62.4 billion in assets in 1988. Among the most prominent recent U.S. acquisitions were the $5.2 billion purchase of Los Angeles-based Farmers Group by B.A.T. Industries of the United Kingdom in 1988, which included substantial life insurance operations, and the purchase of Businessmen's Assurance Company of Kansas City by the Italian insurance company, Generali-Assicurazioni Generali, S.p.A.

The European Community (EC) is directing its members to liberalize their markets for insurance. Several EC countries have opened their life insurance sector considerably to foreign investment, and some U.S. insurers have responded by acquiring local companies and establishing new operations, particularly in Southern Europe.

Table 6: U.S. Insurance Affiliates[1] of Non-U.S. Parents

Item	1983	1985	1987[2]	1988[2]
All insurance				
Number of affiliates	148	147	NA	154
Total assets (mil. $)	53,105	67,199	110,089	139,500
Sales (mil. $)[3]	21,875	23,942	39,106	49,292
Life insurance				
Number of affiliates	41	43	NA	37
Total assets (mil. $)	23,368	33,792	53,258	62,360
Sales (mil. $)[3]	8,828	10,452	16,787	19,902
Other insurance				
Number of affiliates	107	104	NA	117
Total assets (mil. $)	29,737	33,407	56,831	77,140
Sales (mil. $)[3]	13,047	13,490	22,319	29,390

NA—Not available.

[1] Affiliates are entities 10 percent or more owned by any one foreign person. Includes branches and subsidiaries.

[2] Preliminary estimates.

[3] Sales equals premium income plus investment income plus other income.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States*, various issues.

U.S. activity in Europe has been overshadowed, however, by European insurance companies that are consolidating their hold on the local market through acquisitions and mergers and positioning themselves for a pan-European presence. Indeed, as European insurers become larger, they also are becoming increasingly interested in obtaining a larger piece of the U.S. market through acquisition or direct entry.

The key to U.S. companies' long-term opportunities in foreign markets lies in the effectiveness of the rules and principles for trade in services being negotiated under the General Agreement on Tariffs and Trade (GATT). A successful agreement would establish multilateral rules giving signatory countries guidance on international trade and investment in services, including insurance.

Outlook for 1991

Premium receipts of life insurance companies will expand an estimated 1.8 percent in 1991, to $287.2 billion. Premium income from individual annuities will lead the way, with premiums for life and health insurance also showing persistent growth. Employment will remain essentially unchanged.

Long-Term Prospects

Major changes in the market may drastically alter the nature of the industry. Competition for premiums will intensify. New competition will come from other financial service firms, such as banks, which will expand their sales and underwriting capabilities if legal barriers fall. Competition will also come from foreign companies, particularly European companies, that will be looking for a larger share of the U.S. market. Finally, insurers will diversify and expand their product lines.

Demographic variables, such as income growth, wealth accumulation, population and workforce changes, and home ownership will determine the demand for pure insurance products over the long term. Life insurance products with a savings component will have to compete directly with mutual funds, time deposits, retirement savings, and other financial products. (For additional information, see chapter 49, Mutual Funds.) The rate of personal savings in the United States is expected to rise as the baby-boom generation reaches middle age, a time when people tend to save more. Consequently, the market for life insurance products will expand, although profit margins will narrow in the face of increased competition. Some companies will succeed with niche products. The most promising areas for insurers' income growth are annuities and health insurance as aging baby-boomers increase their demand for retirement plans and health insurance.

Employer and individual use of tax-deferred retirement plans will increase over the next five years. Changes in the favorable tax status of IRAs and similar plans may significantly increase the demand for individual annuities. Income generated from group annuity income will increase as employers expand pension programs and benefits—particularly defined contribution plans—for their employees.

The long-term growth in health care premiums will mostly depend on how the United States addresses national health care issues. For example, if proposed mandatory employer-provided health insurance is enacted, it will bring additional business to private health insurers. Conversely, proposals calling for government-funded health care could reduce the role of private health insurance. (For additional information, see chapter 44, Health and Medical Services.)

Life insurance companies will have to reduce costs in order to remain competitive. Pressure will be on to find less expensive distribution systems and to reduce home-office expenses. Direct-mail marketing and sales through other financial institutions, retail outlets, and fee-based agents are some alternative methods to the traditional agency system.

On top of this, the stability and solvency of the industry could be affected by the growing incidence of AIDS, further weakness in real estate markets, and an inordinate amount of high-risk junk bonds in some insurers' portfolios. The industry could be headed for a period of consolidation as noncompetitive companies are acquired. In addition, the loss of antitrust immunity from a revision or repeal of the McCarran-Ferguson Act would further tend to push marginal companies into mergers.

Diminished returns on life insurance in the United States will prompt more companies to look for other investment opportunities. Many life insurance companies have already moved—or will move—into related financial services, including securities, banking, and real estate. More companies will also take advantage of expanding foreign markets, especially in Europe and Asia.

PROPERTY CASUALTY INSURANCE

Net written premiums for property-casualty (P/C) insurance companies grew 4.4 percent in 1990, to $217.6 billion. The downward trend in commercial rates since 1987 leveled off in 1990, but adequate capacity and tough competition kept most rates from rising despite large increases in incurred losses. Coupled with a small increase in investment income, operating earnings after taxes declined sharply, to $5.6 billion. Asset growth slowed, while employment expanded 2 percent, to 557,200 in 1990.

The property-casualty insurance industry consists of companies that underwrite insurance protection for individuals, commercial businesses, and others against losses of real and personal property or losses by third parties for which the insured is liable. P/C insurance companies are classified in SIC 633, (Fire, Marine, and Casualty Insurance,) or in SIC 632, (Accident and Health Insurance). There are an estimated 3,800 P/C insurance companies in the United States. Some are stock companies owned by stockholders, and some are mutual companies owned by policyholders.

Automobile insurance is the single largest source of premium income for P/C insurers, accounting for 43.6 percent of net written premiums in 1989 (Table 7). About 80 percent of automobile premiums written were from individual policyholders. Other major sources of premiums written are workers' compensation, liability lines, homeowners' multiple peril, and commercial multiple peril. Decreases in premiums written for liability insurance in 1988 and 1989 were due mainly to the rate cutting that followed sizable increases in the tight market of 1985 and 1986. Growth in premiums written for automobile insurance and workers' compensation relative to most other lines of business continued in 1990, although these lines also represented the biggest areas of underwriting losses for insurers.

Trends and Forecasts: Property/Casualty Insurance

(in billions of dollars except as noted)

Item	1987	1988	1989	1990[1]	1991[2]	Percent Change 1987–88	1988–89	1989–90	1990–91
Net written premiums	193.2	202.0	208.4	217.6	231.1	4.6	3.2	4.4	6.2
Underwriting gain (loss)	(7.1)	(8.4)	(16.5)	(23.1)	(30.0)	18.3	96.4	40.0	29.9
Net investment income	24.0	27.7	31.2	31.4	32.6	15.4	12.6	0.6	3.8
Operating earnings after taxes	11.0	12.9	9.1	5.6	1.7	17.3	−29.5	−38.5	−69.6
Assets	426.7	476.9	527.0	559.8	592.3	11.8	10.5	6.2	5.8
Policyholders' surplus	104.0	118.2	134.0	138.5	140.1	13.7	13.4	3.4	1.2
Employment (000) (SIC 633)	528.2	540.2	546.1	557.2	561.4	2.7	1.1	2.0	0.8

[1] Estimate.

[2] Forecast.

SOURCE: A. M. Best Company, *Best's Aggregates and Averages*; U.S. Department of Labor, Bureau of Labor Statistics. Estimates and forecasts by U.S. Department of Commerce, International Trade Administration.

Table 7: Net Written Premiums by Major Lines of Business, 1986–89

(in billions of dollars)

Item	1986	1987	1988	1989
Total, all lines	176.6	193.2	202.0	208.4
Automobile, total	73.4	81.2	86.4	90.9
Auto liability	44.1	49.2	52.5	56.0
Auto physical damage	29.3	32.0	33.9	34.8
Liability other than auto	22.9	24.9	23.1	22.7
Fire and allied lines	6.9	7.7	6.9	7.0
Homeowners' multiple peril	15.2	16.7	17.1	17.7
Commercial multiple peril	16.2	17.2	17.7	17.5
Workers' compensation	20.4	23.4	26.1	28.2
Marine, inland and ocean	5.1	5.5	5.5	5.6
Accident and health	2.9	3.8	4.7	4.6
Other lines	13.6	12.8	14.5	14.2

NOTE: Data may not add to totals due to rounding.

SOURCE: A.M. Best Company, *Best's Aggregates and Averages*.

The growth of reinsurance was expected to have been flat in 1990 after two years of decline. Reinsurance is insurance that insurance companies purchase to reduce, or spread, some of the risk they assume. In 1989, about $21.4 billion worth of reinsurance premiums was written. Foreign-based reinsurers assumed $8.6 billion of this business (Table 8). The decline in reinsurance since 1987 has been due mostly to the current soft market and to increased risk retention by direct insurers.

Key Developments in 1990

Government regulation and control of the insurance market was the central theme of developments in the property-casualty industry in 1990. Solvency concerns captured most of the attention of state regulators, Federal lawmakers, and industry officials.

Nothing disrupts an insurance market more than insurers that are unable to meet legitimate claims. The incidence and severity of insolvencies has increased greatly since 1984, although the situation is not as critical as the problems in the savings and loan industry. Since June 1969, more than $3.3 billion has been paid out by state guaranty funds to make up for the unpaid liabilities of bankrupt insurers, the bulk since 1984. Because these payments are charged to solvent insurers, they diminish the financial soundness of the whole industry.

Table 8: U.S. Trade in Insurance

(in millions of dollars)

Item	1986	1987	1988	1989
Primary insurance premiums:				
Exports[1]	2,700	[illegible]	3,157	3,386
Imports[2]	954	1,208	1,112	1,075
Reinsurance premiums:				
Exports[1]	1,714	[illegible]	1,862	1,722
Imports[2]	6,263	7,330	7,875	8,629
Balance of payments for insurance net of losses	−231	−946	−986	564

[1] Premium receipts of U.S.-based insurance companies from foreign-based insureds.

[2] Premium payments of U.S.-based insureds to foreign-based insurance companies.

SOURCE: U.S. International Transactions Data, U.S. Department of Commerce, Bureau of Economic Analysis.

A 1990 congressional investigation found that the number of insolvencies could increase if nothing is done to address the problem. The report questioned the adequacy of state regulation and suggested Federal oversight might be needed.

The National Association of Insurance Commissioners, representing state regulators, has been pressing for tighter state rules to curb perceived industry abuses. Many insurers, mostly the larger ones, and some industry trade associations now believe the Federal Government may have to take a larger role in setting financial standards to protect policyholders. Another idea under discussion is a type of Federal guaranty similar to deposit insurance for banks.

Pressure to end the industry's antitrust immunity comes mainly from consumers who believe insurance, particularly automobile insurance, is too costly and too difficult to obtain. In California, Proposition 103, passed in 1988, required insurance companies to roll back P/C insurance rates 20 percent and removed state antitrust exemptions, although these requirements have been mitigated by the courts. Other states, such as New Jersey and Pennsylvania, have passed similarly motivated measures. In response, many insurers have curtailed affected lines of insurance or pulled out of certain states or lines of business altogether.

Growing antitrust concerns have prompted industry and the state regulators to stop insurance rating bureaus, such as the Insurance Services Office (ISO) and the National Council on Compensation Insurance, from issuing advisory rates that industry critics interpret as a form of price fixing. In 1990, the ISO began replacing advisory rates for some lines of insurance with historical loss information. As a result, insurance companies will have to calculate and file their own rates.

The so-called liability crisis of the mid-1980s, when many businesses were unable to obtain or afford liability insurance, has eased. But the fear is that the next downturn of the insurance market will lead insurers to restrict coverage, and that rates will escalate once again.

The insurance industry continues to support changes in tort law that it hopes will provide more certainty in the conduct of litigation. During the past several years, most states have enacted legislation to address one or more of the perceived problems with their tort litigation system. Product liability remains a particular problem because goods

Israel Matos National Weather Service NOAA

Premiums written by property-casualty insurance companies will rise 6.2 percent in 1991, with auto insurance the biggest component.

move in interstate commerce while the controlling laws vary by state. This creates uncertainty for both sellers and buyers of manufactured goods.

Again in 1990, Congress worked on legislation that would provide some national uniformity in product liability by abolishing joint and several liability for noneconomic damages; set a two-year statute of limitations for bringing suits; and encourage the use of pretrial settlements and other alternative means of settling disputes.

Many businesses and other organizations have responded to the availability and affordability problems by self-insuring. Others have formed wholly-owned captive insurance companies, separately capitalized, to fund employee health care or workers' compensation. Catastrophic coverages in these areas, however, usually are placed in the traditional market. A 1990 survey estimated that risk financing alternatives amount to almost 30 percent of the P/C insurance market, with self-insurance accounting for two-thirds of the alternative market and other alternatives, such as group captives, comprising the rest.

To provide another means of risk financing, the Risk Retention Act of 1981, as amended in 1986, facilitates the formation of risk retention groups and purchasing groups. A risk retention group is capitalized by its members and state-licensed to provide liability coverage to its members. Purchasing groups are formed to buy group insurance from a commercial insurer at a discount.

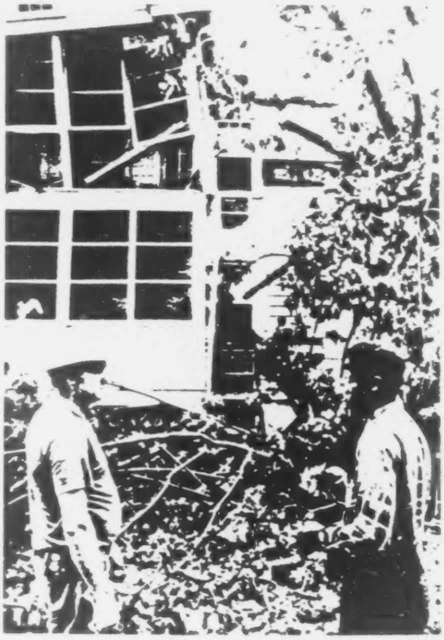
The Secretary of Commerce recommended several amendments to Congress in 1989 to improve operations for groups formed under the act. A principal change would clarify the treatment of purchasing group insurers, allowing them to buy insurance without burdensome regulation. The amendment would also provide safeguards to assure that insurance providers are capable of meeting their financial responsibilities.

In 1990, it was reported that there were 69 risk retention groups, compared with 62 groups with an estimated $399 million of premiums written in 1989. There were 337 purchasing groups that reportedly had premiums written of $575 million in 1988. Environmental impairment, medical malpractice, and product liability are common areas of coverage by risk-retention and purchasing groups.

INTERNATIONAL COMPETITIVENESS

The U.S. property-casualty insurance market is the largest in the world. As shown on Table 3, the United States accounted for almost 46 percent of worldwide premiums in 1988, followed by Japan with 12.7 percent. (The nonlife market on Table 3 includes health insurance premiums and P/C premiums.)

Table 6 shows that the sales (premium income plus investment income plus other income) of U.S. nonlife affiliates of foreign direct investors totaled slightly less than $29.4 billion in 1988. This is a substantial increase from $13.5 billion in 1985. It is estimated that foreign-owned P/C insurance companies accounted for 13 percent, or about $26.0 billion, of P/C premiums written in the United States in 1988. For all lines of insurance, foreign-owned companies received about 9.3 percent, or $40 billion, of premium receipts in the United States in 1988.



GEICO/Government Employee Insurance Company

Despite growing losses from claims, stiff competition will keep property-casualty rates from rising in 1991.

Table 5 shows that Canada, the Netherlands, and the United Kingdom had the most active U.S. insurance affiliates in 1988. The foreign-owned share of the U.S. market is expected to increase substantially. In 1989, BAT Industries of the United Kingdom acquired the Farmers Group, the tenth largest P/C insurance group in the United States, with $4.7 billion of premium income in 1989. In a deal expected to be consummated in early 1991, Europe's largest insurance company, the Allianz Group of Germany, will purchase Fireman's Fund Insurance Company, the 23rd largest P/C insurance company in the United States,

Foreign P/C insurance affiliates of nonbank U.S. parents had $16.2 billion of sales in 1988 (Table 4). This was down slightly from $17.0 billion in 1987. Europe and Canada were the largest sources of foreign business for these affiliates, although Japan and Latin America were also important markets for U.S. insurance affiliates abroad (Table 6).

Several events have enhanced the prospects for U.S. insurance companies to expand into international markets. In 1986, Korea and Taiwan opened their domestic insurance markets to American insurance companies, and many U.S. P/C insurers have opened offices in these and other Asian countries. In addition, a multilateral framework for trade in services is being negotiated under GATT. A successful agreement would create worldwide opportunities for all U.S. insurance companies.

The European Community holds great promise for property-casualty insurance companies. Insurers in one EC country will be able to write certain business in any other EC country. In addition, the EC has issued a directive that partially standardizes product liability laws among its members. Some U.S. insurers have already positioned themselves to take advantage of the business opportunities in the EC.

Outlook for 1991

Net written premiums for property-casualty insurance companies will increase 6.2 percent in 1991, to $231.1 billion. Commercial rates will begin to rise late in 1991 if the current soft market ends. However, rates will not rise enough to offset growing losses from claims. Thus, underwriting losses will reach new levels. Investment income will grow little, barely keeping insurers' overall operating earnings positive. Asset growth will be below normal because of poor earnings. Some P/C companies will experience severe financial difficulties and the incidence of insolvencies will remain high, but manageable.

Long-Term Prospects

After they begin to rise, rates for commercial insurance will continue to rise for a couple of years. Competition in the industry will keep rates from rising too fast or too far. In addition, insurers will be reluctant to raise rates too much, lest they produce a public backlash. Expectations are that rates will rise modestly across most lines of business rather than in selected lines, as happened during the liability crisis. The movement to alternative methods of risk financing will dampen growth in the industry and increase the relative amount of catastrophic risk carried by P/C insurers. Ultimately, this could affect the solvency of the industry.

Competition from foreign insurance companies will increase. Many foreign companies already compete in the U.S. reinsurance or surplus lines market, or both. As the EC insurance market consolidates, European insurers will move even more strongly into the U.S. market, primarily through acquisitions.

Market liberalization in the EC offers U.S. property-casualty insurers the biggest opportunity to expand overseas. American insurers also will expand into Asian as well other foreign markets. A global economy with increasing international trade and investment and with large and growing multinational companies will require insurance companies that have a worldwide presence.

The prospect for some form of federal regulation will increase in the next few years, especially if solvency problems grow. The insurance industry also will be affected by how such major problems as escalating health-care costs are resolved.—*M. Bruce McAdam, Office of Service Industries, (202) 377-0346, September 1990.*

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1990 Property/Casualty Insurance Facts, Insurance Information Institute, 110 William Street, New York, NY 10034. Telephone: (212) 669-9200.

Best's Aggregate and Averages, A. M. Best Company, Oldwick, NJ 08858. Telephone: (201) 439-2200.

Business Insurance, 740 Rush Street, Chicago, IL 60611. Telephone: (312) 280-3174.

Liability Risk Retention of 1986, Operations Report, 1989, U.S. Department of Commerce, Washington, DC 20230. Telephone: (202) 487-4650

Life Insurance Marketing and Research Association, Inc., P.O. Box 208, Hartford, CT 06141. Telephone: (203) 677-0033.

National Association of Insurance Brokers, 1401 New York Avenue, Washington, DC 20005. Telephone: (202) 628-6700.

National Association of Insurance Commissioners, 120 West 12th Street, Suite 1100, Kansas City, MO, 64105. Telephone: (816) 842-3600.

National Underwriter, National Underwriter Company, 43-47 Newark Street, Hoboken, NJ, 07030. Telephone: (201) 963-2300.

Reinsurance Association of America, 1025 Connecticut Avenue, NW, Suite 512, Washington, DC, 20036. Telephone: (202) 293-3335.

Risk Retention Reporter, Insurance Communications, P.O. Box 5014, Pasadena, CA 91115. Telephone: (818) 796-4972.

Sigma, Swiss Reinsurance Company, 50/60 Mythenquai, P.O. Box 8022, Zurich, Switzerland. Telephone: (01) 208-2543.

Source Book of Health Insurance Data, Health Insurance Association of America, 1025 Connecticut Avenue, NW, Washington, DC 20036. Telephone: (202) 223-7845.

Senator EXON. Let me inquire of these two witnesses. In your view, will the level of insurance company insolvencies during the next 10 years be greater or less than the insurance company insolvencies in the last 10 years?

Mr. FINCH. OK. I think, I cannot answer your question with an answer founded in analysis, sir. Most of the work that we have been requested to do to date has been descriptive in nature in terms of how processes work and what the States do.

So, we have not done the kind of financial analysis that would permit us to comment on the financial condition either of an individual company or of the industry in general.

Senator EXON. Thank you.

Ms. Powers, my question was, from what information that you have available to you now, and I recognize that it might not be in toto, what would be your view on the next 10 years compared with the previous 10 years as to the likelihood of insurance company failures being larger or smaller?

Ms. POWERS. Our best projection that we have set forth in the Outlook chapter anticipates that the level of insolvencies on the property casualty side, which is the main area of concern, would remain at about the same as it has been for the last 7 years, since the increase that occurred in 1984, for at least the medium term.

I am not sure that takes us out a full 10 years, but for the medium term.

Senator EXON. From what both of you know now, do you feel that there is a need for some type of Federal standards or guidelines with regard to insurance companies' solvency?

Ms. POWERS. We at Commerce do not have a position on that point yet. It is one of the types of policy recommendations that is being addressed as part of the large study we are working on with Treasury, so that we will be developing that position, but it does not exist at this time.

Senator EXON. Mr. Finch.

Mr. FINCH. I guess I would respond similarly, sir. I do think there is a need for greater uniformity and greater certainty in the process. But the issue that is still unresolved I think is whether that can be accomplished through the State process or whether Federal intervention is needed in some form or fashion.

Senator EXON. I am going to read you a statement from Chairman Dingell, Chairman of the House Energy and Commerce Committee's jurisdiction. And Chairman Dingell used this in a cover letter I believe sometime in February 1990.

And I quote: "The parallels between the present situation in the insurance industry and the early stages of the savings and loan debacle are both obvious and deeply disturbing. They encompass scandalous mismanagement and rascality by certain persons entrusted with operating insurance companies, along with an appalling lack of regulatory controls to detect, prevent, and punish such activities."

I am trying to get a fix, once again, on where you, as important Federal servants involved in this area, what is your reaction to that statement, including some allegations by Chairman Dingell?

Ms. POWERS. From a Commerce Department perspective, we are not in a position to agree or disagree with the accuracy of that assessment since we do not have a regulatory capability or assessment function.

But what I would like to say and emphasize is that we share very much the degree of concern about the importance of getting to the bottom of those issues because the financial soundness of the industry, obviously, has a direct impact on its competitiveness, and therefore, the ability of the industry in the areas that we are responsible for to take advantage of market opportunities.

Senator EXON. Mr. Finch.

Mr. FINCH. We participated to a degree in Chairman Dingell's study, Senator Exon. And let me elaborate just a bit on that and the outcome of it in response to your question.

He was looking particularly at the time at Mission and Transit insurance companies, which are the two largest and most expensive failures. And his staff had come up with a list of causes or characteristics that were similar to both of those insurance companies, to the two of them.

He asked us to compare that list of characteristics with the characteristics of failed thrifts that we had been looking at. In essence we had been looking at 26 thrifts with high-resolution costs. At the time, I think, they were the highest cost thrifts that had failed during the 21 months preceding September 30, 1987.

We found that 10 of the 11 characteristics were also present in each of the 26 thrifts. Some of these characteristics included: growth orientation on the part of management, trying to expand too fast into markets where they had very little experience or expertise; excessive underpricing and poor underwriting; just generally imprudent management practices; long lapses between examinations on the part of the regulator; and some, just generally, inadequate internal controls. There were others as well.

But we would add now, based upon subsequent work, perhaps the unwillingness or the inability of regulators to act quickly to identify and resolve the questions.

We can speak only to the instances of the two companies, Mission and Transit in terms of the insurance companies and to the 26 thrifts. So, we cannot really generalize across both industries. Nevertheless, in the instances of the failed institutions there are some striking similarities.

Senator EXON. My time is up. I have more questions. I will wait for the second round.

Senator BRYAN. Senator Gorton.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Mr. Chairman, I have a brief opening statement. I ask that it be included in the record as read.

Mr. Chairman, I would like to thank you for calling this hearing on insurance company insolvencies. In the wake of the savings and loan crisis, it is important for the committee to exercise its jurisdiction over the insurance industry to determine whether it is stable, and whether the current regulatory structure is adequate to guard against widespread insolvencies.

The insurance industry is a powerful force in our economy. With $1.75 trillion in assets, it is a major investor in stocks, bonds, and other financial markets. Moreover, insurance is an essential service for all Americans as well as businesses.

The committee will examine the stability of the insurance industry. We will attempt to discern whether the industry is in good condition. We also will focus our inquiry on the state regulatory system. Regulation is crucial to the effort to maintain a viable industry.

Today's witnesses will provide important insights into these questions, Mr. Chairman. I look forward to hearing their testimony, and I understand that industry witnesses will have a chance to share their views with the committee in the near future.

Thank you.

Mr. Finch, on the first page of your testimony one of the four concerns that you note is, and I quote, "that there are wide variations among the States in both the resources devoted to regulatory oversight and the authorities that regulators have to compel behavior that fosters a solvent insurance industry."

Then, back on page 8, you give a couple of examples, such as reviewers to annual statements: 1 to 79 in Connecticut to 1 to 792 in Arizona. Later on that page you speak about a new NAIC certification program under which only two States, Florida and New York, have been certified.

Is that original statement about these wide variations simply a truism that we have all heard for so many years that it can find its way into a GAO report? Or do you have some more specific indication which would allow you to tell me beyond these two statements I have outlined that a given half- dozen States or a dozen States that you know about seem to you to have really good, adequate programs and perhaps there are half-dozen on the other end about which you are alarmed?

Mr. FINCH. I think, sir, we can speak more to the aspect of here are the variances that exist as opposed to the qualitative assessment of which of the programs is really the best or that we would hold up as a model.

If you are interested in a couple of other examples of variances, perhaps my colleague can——

Mr. CLUFF. The fact that the States have substantial differences in both resources and funding as well as in the sense of laws and authorities and regulations that they have to work with is widely known. And it is true based on the work that we have done. We have not assessed all 50 States in one stroke to identify the specific differences that exist.

In our work over the last several years we have found a number of cases where certain laws either do not exist in some States or where there are differences like the example you noted in terms of resources.

We were unable to find a readily available criteria to tell us how many resources were enough. However, I think the NAIC's actions during last year indicate their concern with the variance and the sometimes low levels of resources available to States. And that is why they included it as part of their certification program, that a certain minimum level of funding and resource capability be available.

It is very difficult to identify evidence that says these differences contribute to specific failures or lack of failures. In fact, there is some evidence that suggests that the best States have more failures, those that are considered to be the best States, like perhaps New York and California and others have the most failures. Now, one might suggest that perhaps it is that they are more active or proactive in their regulatory activities.

It is difficult to look at what is happening in the States and say this one is a good one and that one is a bad one based on the outcome of the regulatory process. There is considerable widespread belief that variations in quality of regulation do exist. And we believe that as well based on the overall of our work.

Senator GORTON. Thank you.

A question primarily for the two of you, for the GAO, and Ms. Powers can answer it as well if she wishes.

To what extent, in your view, are problems or potential problems in the property and casualty field due to expanding theories of legal liability, asbestos for example, product liability, lawsuits, the increasing size and frequency of punitive damage awards? To what extent does that put property and casualty insurance solvency at risk?

And to what extent would those problems be obviated or at least lessened if there were any kind of national approach to limiting recoveries in cases of that nature?

Mr. FINCH. It would be purely speculative on our part. We have not done the kind of analysis that would enable us to respond with informed precision to your question.

Ms. POWERS. That is an issue that the Commerce Department, Secretary Mosbacher in particular, have been talking extensively with various industry sectors about. We share the concern about product liability situation as a contributing factor, cannot quantify it and do not have a specific solution yet. We would not, at this time, recommend a Federal approach such as you said.

Senator GORTON. Ms. Powers, you are Deputy Assistant Secretary for Services. You are here today. I assume that means insurance is one of the services over which you are Deputy Assistant Secretary.

Ms. POWERS. Correct.

Senator GORTON. Is there some person below you on the organization chart in the Department of Commerce who has just insurance as his or her responsibility?

Ms. POWERS. Yes, there is. There are several tiers, but the key person is the industry analyst who is specifically on the insurance industry.

Senator GORTON. Then how much does that mean that you do or know within the Department of Commerce with respect to both regulatory structure and solvency issues?

Ms. POWERS. We put a fairly extensive amount of work into that area because it is important to our work in the trade field because of the effect of the solvency situation, as I mentioned, on competeiveness. Also it has become a very frequent topic of discussion in our negotiations on trade barriers.

Trade barriers in foreign markets are increasingly the subtle and sophisticated regulatory aspects. And the foreign trade officials are increasingly pointing the finger at our own situation. We have to respond to that. So, we are actually doing quite a lot. Market areas include Europe, Mexico, Japan, Korea, Taiwan, and India as the primary areas of activity for insurance, specifically.

Senator GORTON. Thank you, Mr. Chairman.

Senator BRYAN. Thank you, Senator Gorton. Senator Pressler.

Senator PRESSLER. Following up on the last question by Senator Gorton, Ms. Powers, I note on page 6 of your testimony that you talk about the Uruguay Round of negotiations. Maybe this has been covered already. If so, I will read it in the record.

Where do we stand now that the GATT talks have broken down with respect to the portion regarding services?

Ms. POWERS. The portion that is referred to here which is the framework agreement and the provisions on services and financial services in particular, is on hold.

I would point out, though, a very great deal of activity is going on right now to try to progress further on services. And what this activity is is the specific discussions, country by country, on market opening commitments.

Senator PRESSLER. OK. But the GATT agreement does not normally include services; is that not correct? Or am I wrong?

Ms. POWERS. This would be the first time.

Senator PRESSLER. It would be the first time that services are covered.

What are the chances of that happening? Very slim?

Ms. POWERS. We are going to make the maximum effort anyone can make to produce that result.

Senator PRESSLER. That would be the ultimate in free trade, would it not? Eventually, I think the world will have to come to something like the Uruguay Round agreement in services.

But has the stalling of the GATT talks affected this? I suppose, obviously, it has.

Ms. POWERS. It has affected it in the sense that it has affected all of the areas that were under negotiation, including services. But service is a particular area where, more so than other areas, activity is still continuing.

Senator PRESSLER. What is going on? What is happening right now?

Ms. POWERS. There are two types of activities involved in those negotiations. One was working out a set of rules and principles. And the other was negotiating a specific set of market opening commitments where countries took out a given unfair licensing procedure or a given discriminatory capital requirement or this type of thing, real specific, and on a country-by-country basis. That latter type of activity is going on right now.

Senator PRESSLER. I see. Do we normally handle those by bilateral agreements in terms of services? Are they handled in bilateral agreements currently?

Ms. POWERS. For example, goods are covered in a multilateral way in the existing GATT agreement. But procedurally, to work out the specific concessions that each country makes to take out existing barriers, you have to sit down, almost necessarily, on a one-by-one basis. But then it all gets rolled together into the overall package as part of the multilateral regime.

Senator **PRESSLER**. Thank you. I might address this question to one of the two gentlemen.

Do you believe that regulation of reinsurance accounting is adequate? How could regulators allow a company to misrepresent the value of the reinsurance it carried as occurred in the Mission and Transit cases?

Mr. **FINCH**. I think the reinsurance area needs a lot of work in terms of financial reporting and more certainty about how much reinsurance really exists. Obviously, reinsurance is insurance for insurance companies and the primary insurer remains liable if the reinsurer is unable to pay its respective share. The primary insurer can incur a really big loss.

Part of the problem with the financial data that is available to the regulators now is that it is really difficult to tell how much reinsurance exists, either on the part of individual companies or across the industry as well. And a more important point, perhaps, is the extent of reinsurance that is generated from the international sector where the States do not really have regulatory authority to deal with non-U.S. reinsurers.

In fact, I think Commerce in its figures that Ms. Powers cited earlier, or in its report at least, points out that about one-third, maybe better than one-third of total reinsurance is written by non-U.S. insurers.

Mr. **CLUFF**. I would add, we did a report on reinsurance regulation, and I would direct your attention to it. We have a lot of details there, about the nature of reinsurance, its regulation, and the nature of the data that are available to assess the reinsurance industry.

The NAIC has taken some very effective steps in the last couple of years to improve the quality of the data that they collect and that the States collect from insurance companies, identifying both who they do reinsurance business with and the quality of the reinsurance recoverable from those companies, the aging and the quality of that asset.

Senator **PRESSLER**. Thank you, Mr. Chairman.

Senator **BRYAN**. Thank you very much, Senator Pressler.

Senator Exon indicates he has one more question to ask and then we want to announce that we will keep the record open on this so that each of the committee members—some of whom were not able to join us today—will have an opportunity to submit questions to you, and we would certainly appreciate your response to that.

Senator Exon.

Senator **EXON**. Mr. Chairman, thank you.

Some of the good questions that were asked by Senator Pressler and Senator Gorton were ones that I wanted to ask, and I thank you for your reply.

Let me try and wind up this portion of the questioning with a question to the GAO. How would the GAO rate the effectiveness, the overall effectiveness of the NAIC—we know that you have given some approval to New York and Florida, and I am sure that there are degrees of success in regulation that vary all over the lot, that I think you have found in your preliminary investigations.

But how would GAO rate the overall effectiveness of the National Association of Insurance Commissioners in meeting the needs regarding insolvency standards?

Mr. FINCH. I think, sir, NAIC is doing a commendable job. One has to keep in mind that it is a voluntary organization, that is composed of the Commissioners of each of the 50 States.

I think some key issues in terms of NAIC's effectiveness are its enforcement authority and the resources that it has to bring to bear in applying that enforcement authority. I think that they have done a good job in recognizing the need for more uniform standards. I think they have done a good job in working with the States to try to bring those things about.

Notwithstanding, there are still the issues of the enforcement authorities they can bring to bear and the resources that they can apply in the process.

Mr. CLUFF. May I add something? We are in the middle of a very detailed study of the National Association of Insurance Commissioners, at the request of Congressman Dingell, and expect to report the results of that study sometime in the spring at hearings before his Oversight and Investigation Subcommittee.

It is probably, therefore, premature to assess them at this point since we are really doing that work.

Senator EXON. But I am asking you to. [Laughter.]

Mr. CLUFF. I understand that, sir. And I stand by Mr. Finch's statement: They do a lot of very useful and important things for State insurance regulation. We are looking at whether they are effective in all of the things that they do, in particular, the certification program.

I would add that NAIC is being very cooperative in our study of them, and have provided us with every help that we have asked for to this point.

Senator EXON. Well, just let me close with a comment then, Mr. Chairman. I believe the only reason that we have not had Federal intervention in the insurance industry previously was the long record of generally good regulation of the insurance industry by the NAIC.

And I remember back when I was Governor, when I guess we had favorably, a very positive economic upbeat and there was not a lot of financial difficulties, it is always easier to make an assessment in those good old days of the past. I know that we are down to a different scenario today.

I have been a great backer of the NAIC and continue to be, but, as you said, Mr. Finch, it is a voluntary organization, but yet at one time that voluntary organization was so effective and so intermeshed and interwoven and carried out their duties in such a fashion that there was little, if any, need for the consideration of Federal intervention and Federal rules and regulations in this whole area.

I may be wrong, but I felt that that organization over the years was probably not quite as strong or quite as effective or worked quite as well together as they once did.

I have received some indications that, given the difficulties that have now surfaced, that maybe that organization is going to rekindle their spirit and maybe really get back into the position of recognizing that we have 50 States that have rules and regulations but they were pretty much interwound with each other on a reciprocal basis.

I hope that that will continue. If that does not continue and if that is not effective, even though it is a volunteer organization, then it is forward aim, Mr. Chairman, that the Federal Government, whether it wants to or not, will likely be drawn into the regulation of the insurance industry.

So, I think the heart and soul of all of this is how good a job that organization does as the National Association of Insurance Commissioners in the immediate future. And I encourage them to come to the fore once again.

Thank you for your testimony.

Thank you, Mr. Chairman.

Senator BRYAN. Thank you very much, Senator Exon.

Let me thank each member of the panel this morning. We appreciate very much your appearance here and we will have some followup questions. We look forward to your response to those as well.

Our second panel this morning will consist of Larry Mayewski, Vice President, Life and Health Division, A.M. Best Co.; John H. Snyder, Vice President, Property and Casualty Division of A.M. Best Co.; Roy Taub, Executive Managing Director of the Insurance Rating Services, Standard and Poor's Corp.; and Orin Kramer, President of Kramer Associates of the Information Institute.

Mr. Mayewski, can we begin with you? It is a pleasure to have you here with us this morning. We will now hear from you, sir.

STATEMENT OF LARRY MAYEWSKI, VICE PRESIDENT, LIFE AND HEALTH DIVISION, A.M. BEST CO., OLDWICK, NJ

Mr. MAYEWSKI. It is our pleasure to be here. The A.M. Best Co. would like to thank the committee for the opportunity to comment on the status of the insurance industry and insurance company insolvencies.

My presentation will include a brief overview of the A.M. Best Co., a status report on the financial health of the life insurance industry, and a review of the scope and magnitude of insolvencies within the life-health sector.

My colleague to my right, Jack Snyder, will provide at the conclusion of his report a list of recommendations regarding solvency management that are applicable to both the life-health and property casualty industries.

As an introduction, the A.M. Best Co. is an independent organization which has been engaged in the business of preparing financial reports and evaluating the operating and financial performance of insurance companies since the turn of the century.

Our various information services provide the most complete source of industrywide financial data available. Our annual publications contain ratings, reports and opinions on approximately 1,500 life-health companies and 2,400 property-casualty insurers. This population represents over 99 percent of both the life-health and property-casualty industry asset base. Best Insurance Reports, International Edition, contains reports on nearly 850 foreign insurers.

Because of our 90-year association with the insurance industry, we are often requested to address certain industry topics and/or concerns through various public forums. Of particular interest to the Commerce, Science, and Transportation Committee would be our recent testimony to the Senate Judiciary Committee, which has been provided for your committee's review.

Since the late 1970's the life insurance sector has undergone substantial fundamental changes in response to several factors which include double-digit interest rates, the flow of substantial dollars into money market and mutual funds, and rate deregulation in the banking industry.

These factors reshaped competitive environments and consumers attitudes toward traditional life insurance and created demands for interest-rate-sensitive products. The life insurance industry responded by introducing new products which increased consumers' investment returns.

As a result, profit margins declined and insurers reached for higher yielding investments which increased their investment risk.

From our perspective, we are concerned with the public, political and regulatory issues confronting the industry. While we respect the intent and purpose of many of the studies and analyses which have recently cast doubt on the insurance industry's financial integrity, and we acknowledge that risk levels in the insurance industry have risen, we do not support the dire conclusions predicting potential insolvencies of several large and prominent insurers.

We do not agree that the insurance industry as a whole is on the brink of financial crisis, analogous to that of the savings and loan industry.

While industry aggregations and medians do not represent the performance of specific subsectors and individual companies, the life-health insurance industry has achieved steady growth in its asset base, investment income, and premiums.

Estimated 1990 earnings in the life insurance sector should exceed record profits of $10.5 billion recorded in 1989. The favorable aggregate earnings performance achieved over the past several years has resulted in steady growth in capital and surplus funds.

When the relationship of surplus to liabilities is reviewed, an argument can be made that the industry as a whole has maintained its secure financial standing, especially in relation to other financial services industries.

This brings me to the specific topic of solvency. Increased competition has led to an increase in failure rates. This is evident in the accelerated insolvency rate during the 1980's.

The A.M. Best Co. is compiling an in-depth analysis of insolvencies within the life-health and property-casualty industries. Although the A.M. Best Co. has not yet completed its solvency study of life-health insurers, our records indicate that insurance company failures have not been directly related to issues such as less than investment grade bonds, nonperforming mortgage loans, or depressed real estate values.

While specific carriers have recently experienced a strain from current industry and economic conditions, preliminary findings point to the following as contributors to insurance company failures in the life insurance industry: mismanagement, transactions with affiliated companies, excessive growth, inadequate underwriting practices including underpricing, significant change or shift in business mix, excessive utilization and misuse of reinsurance, and fraud.

The ability of the A.M. Best Co. to measure and monitor policyholder security through the assignment of Best ratings have been very effective.

Over the past 10 years, approximately 91 percent of the life-health companies which were declared insolvent did not qualify for assignment of a Best rating or did not even file their annual statutory statement with the A.M. Best Co.

In fact, nearly 88 percent of the life-health companies declared insolvent over the past 10 years did not qualify for an alphabetical Best rating or did not file their financial statements with our organization within 3 years of insolvency.

A point worth noting is that no life-health company which became insolvent ever carried our highest rating of A-plus, and since 1980, only six companies which were declared insolvent were assigned, at the time of failure, a Best rating of B or above.

It is important to note that in the case of virtually all insolvent rated carriers events within these companies were taking place in such a manner, at such a rapid pace, that detection and prevention of insolvency became exceedingly difficult for anyone involved.

From a size standpoint, since 1981 the median surplus and premium level of insolvent carriers was approximately $5.4 and $1.8 million, respectively. Nearly one-half of the companies declared insolvent were engaged in accident, health lines of business, which are inherently riskier than traditional life and annuity lines, and approximately one-third of the insolvencies were concentrated in three States.

Going forward, competition will continue to contribute to a reduction in weak companies through voluntary withdrawal from the marketplace and insolvency. However, it is also important to emphasize that we have seen many companies refocusing their efforts on the fundamentals. Expense control, target profit margins, asset-liability management, balance sheet quality, and surplus adequacy are being emphasized throughout the life insurance industry.

As a result we do not expect the frequency of life insurance insolvencies to dramatically escalate from recent levels in the near term.

We would like to thank the committee for the opportunity to comment on such an extremely important topic. We extend the support of the A.M. Best Co. to be of whatever additional help we can to the committee in the future.

Thank you.

[The prepared statement of Mr. Mayewski follows:]

PREPARED STATEMENT OF MR. MAYEWSKI

The A.M. Best Co. would like to thank the committee for the opportunity to comment on the status of the insurance industry and insurance company insolvencies. As an introduction, the A.M. Best Co. is an independent organization which has been engaged in the business of preparing financial reports and evaluating the operating and financial performance of insurance companies since the turn of the century. Our various information services provide the most complete source of industry-wide financial data available. Our annual publications contain ratings, reports and opinions on approximately 1,500 life/health companies and 2,400 property/casualty insurers. This population represents over 99 percent of both the life/health and property/ casualty industry asset base. Best's Insurance Reports. International Edition, contains reports on nearly 850 foreign insurers.

Because of our over 90-year association with the insurance industry, we are often requested to address certain industry topics and/or concerns through various public forums. Of particular interest to the Commerce, Science, and Transportation Committee would be our recent testimony to the Senate Judiciary Committee, which is provided for your committee's review.

Since the late 1970's, the life insurance sector has undergone substantial fundamental change in response to several factors which include: double-digit interest rates, the flow of substantial dollars into money market and mutual funds, and rate deregulation in the banking industry. These factors reshaped competitive environments and consumers attitudes toward traditional life insurance and created demands for interest-rate-sensitive products. The life insurance industry responded by introducing new products which increased consumers' investment returns. As a result, profit margins declined and some insurers reached for even higher yielding investments which increased their investment risk.

From our perspective, we are concerned with the public, political and regulatory issues confronting the industry. While we respect the intent and purpose of many of the studies and analyses which have recently cast doubt on the insurance industry's financial integrity, and we acknowledge that risk levels in the insurance industry have risen, we do not support the dire conclusions predicting potential insolvencies of several large and prominent insurers. We do not agree that the insurance industry as a whole is on the brink of financial crisis analogous to that of the savings and loan industry.

While industry aggregations and medians do not represent the performance of specific subsectors and individual companies, the life/health insurance industry has achieved steady growth in its asset base, investment income and premiums. Estimated 1990 earnings in the life insurance sector should exceed record profits of 510.5 billion recorded in 1989. The favorable aggregate earnings performance achieved over the past several years has resulted in steady growth in capital and surplus funds. When the relationship of surplus to liabilities is reviewed, an argument can be made that the industry as a whole has maintained its secure financial standing, especially in relation to other financial services industries.

This brings me to the specific topic of solvency. Increased competition has led to an increase in failure rates. This is evident in the accelerated insolvency rate during the 1980's. The A.M. Best Co. is compiling an in-depth analysis of insolvencies within the life/health and property/casualty industries. Although the A.M. Best Co. has not yet completed its solvency study of life health insurers, our records indicate that insurance company failures have not been directly related to current issues such as less than investment grade bonds, nonperforming mortgage loans or depressed real estate values. While specific carriers have recently experienced a strain from current industry and economic conditions, preliminary findings point to the following causes of insurance company failures in the life/health industry.

—Mismanagement
—Transactions with affiliated companies
—Excessive growth
—Inadequate underwriting practices (underpricing)
—Significant change in business mix
—Excessive utilization and misuse of reinsurance
—Fraud

I believe it is important to point out that the A.M. Best Co.'s track record in the detection of insolvency has been very favorable. Over the past ten years, approximately 91 percent of the life/health companies which were declared insolvent did not qualify for assignment of a Best's Rating, or did not even file their annual statutory statement with the A.M. Best Co. at time of insolvency. In fact, nearly 88 percent of the life/health companies declared insolvent over the past ten years did not qualify for an alphabetical Best's Rating or did not file their financial statements with the A.M. Best Co. within three years of insolvency. A point worth noting is that no life/health company which became insolvent carried our highest rating of A+ at that time, and since 1980, only six companies which were declared insolvent were assigned, at the time of failure, a Best's Rating of B or above. It is important to note that in the case of virtually all insolvent rated carriers, events within these companies were taking place in such a manner and at such a rapid pace that detection and prevention of insolvency became exceedingly difficult for anyone involved. From a size standpoint, since 1981 the median surplus and premium level of insolvent carriers was approximately $5.4 million and $1.8 million, respectively. Nearly one-half of companies declared insolvent were engaged in accident and health lines of business (which are inherently riskier than traditional life and annuity lines) and approximately one-third of insolvencies were concentrated in three states. Going forward, competition will continue to contribute to a reduction in weak companies through voluntary withdrawal from the marketplace and insolvency. However, it is also important to emphasize that we have seen many companies refocusing their efforts on the fundamentals. Expense control, target profit margins, asset/liability management, balance sheet quality and surplus adequacy are being emphasized throughout the industry.

Although we do not expect the frequency of industry insolvencies to dramatically escalate from recent levels in the near-term, it is our opinion that a strengthened system of insurance regulation in order to increase the detection and prevention of insolvency and preserve the relative financial strength of the industry in the future would include some of the following features: (We will develop a more comprehensive list of recommendations in our formal solvency study to be issued in a few months).

1. State regulators should include a formal review of the companies that A.M. Best identifies as potentially "high risk" candidates. Our annual review, combined with our 6- and 9-month monitoring identifies hundreds of companies that potentially warrant closer regulatory examination. Our ability to identify companies that are potentially facing difficulty has been proven to be very successful and our analysis should supplement the regulator's role. Companies that are not reported on by A.M. Best also warrant closer regulatory attention.
2. More frequent financial examination of companies that exhibit high risk operating characteristics as outlined in our solvency study.
3. More frequent examination of newer, or unseasoned, companies.
4. More standardized adjusted capitalization requirements to reflect the different level of risks associated with different types of insurance coverage.
5. Stiffer fines and penalties to deter misleading or fraudulent financial reporting.

We would like to thank the committee for the opportunity to comment on such an extremely important topic. We extend the support of the A.M. Best Co. to be of whatever additional help we can to the committee in the future.

A.M. BEST OVERVIEW ON THE FINANCIAL CONDITION AND SOLVENCY ISSUES IN THE LIFE/HEALTH INSURANCE INDUSTRY

The A.M. Best Co. is an insurance publishing and analytical firm which has been engaged in the business of preparing financial reports and evaluating the operating and financial performance of insurance companies since the turn of the century. Best's various products and services provide the most complete source of industry-wide data available.

In keeping with continually changing economic and insurance industry market conditions, our reporting procedures have evolved to provide more comprehensive and timely statistical and financial reporting on the history, operating results and relative financial standing of the vast majority of domestic life/health and property and casualty insurers. Presently, our publications contain ratings and opinions on approximately 1,500 life/health and 2,400 property/casualty insurers operating in the U.S. (which represents over 99 of both the life/health and property/casualty industry asset bases). Beginning in 1985, Best's financial reporting was expanded to include financial information on non-U.S. domiciled -insurance companies. At present, Best's Insurance Reports. International Edition, contains financial reports on nearly 850 foreign insurers.

Because of our over 90-year association with the insurance industry, we are often requested to address certain industry topics and/or concerns through various public forums. Of particular interest to the Commerce, Science, and Transportation Committee would be the recent testimony which was submitted by the A.M. Best Co. to the Senate Judiciary Committee. This material, which was presented on December 10, 1990, will also be provided for the Commerce, Science, and Transportation Committee's review.

As a result of the dynamics within the industry, and in light of current economic conditions, unprecedented public and political debate has arisen regarding the present and future financial standing of the life/health insurance industry. Although many of the resulting analyses and opinions of the industry as a whole have been well intended, the dire conclusions which have been reached indicating that the industry's financial condition is analogous to that of the thrift industry is misleading. Further, we do not support some of the specific suggestions which have recently surfaced regarding the potential for the insolvency of several large and prominent life/health insurers. While signs of changes in the profile of insurer's assets, liabilities, products and profit structures are present, such elements by themselves should not be interpreted that, in the aggregate, the industry is on the brink of a financial crisis.

In recent years, the life/health industry has achieved steady growth in its asset portfolio, investment income, premiums written and, consequently, its capital and surplus base. Estimated 1990 earnings from insurance operations are expected to exceed the record profits of $10.5 billion recorded by the industry in 1989 (exhibit 1). As a basic measure, industry capital and surplus funds in relation to total liabilities over the past 10 years have declined from a high of 9.5 in 1980 to approximately 9.0 percent as of year end 1990 (when adjusted for Mandatory Securities Valuation Reserves--exhibit 2). When the relationship of surplus to liabilities is reviewed, an argument can be made that the industry as a whole has retained its relatively secure financial standing—especially as compared to other financial services industries.

1Within any highly competitive environment, such as the insurance marketplace, industry trends and aggregations may obscure the performance of any individual companies or market segments. However, with regards to the current financial condition of the life/health industry, it is necessary to view overall performance and trends in the context of the rapid changes in products and liability structures which has been experienced - particularly within the past 15 years.

Fueling such dramatic industrywide changes during this time period were the rising interest rate environment experienced during the late 1970's and early 1980's, and the increased competition for investable consumer dollars which arose from the deregulation of the broader financial services industry. In connection with these events, consumer attitudes toward the role of traditional life insurance products as part of personal savings plans were significantly transformed, placing a greater demand on insurers for new products which better reflected current market interest rates. As can be seen in exhibit 3, this transition and new product development has contributed to a general decline in the overall profit margins generated on traditional life insurance products.

Also, the increased consumer interest in current market returns and tax-advantaged savings on insurance investments has fostered considerable growth in annuity writings. Exhibit 4 depicts the expanded role which annuities have had on the industry, in terms of both premiums and insurance liabilities. As is evidenced, annuity liabilities (including guaranteed interest contracts and pensions) have grown from approximately 35 percent of total life insurance obligations in 1979 to nearly 65 percent of life insurance liabilities at the close of 1989. This increased emphasis on annuities, along with the development of interest sensitive life insurance products, has resulted in a fundamental change in the composition of industry liabilities and profit structures (exhibit 5).

The response to the increased competition in the marketplace and the ensuing changes incurred on liability, product and pricing profiles have been mixed. Some companies have remained focused in their operations by concentrating on specialized "niche" markets and/or exercising increased expense and production controls. Others have sought to maintain previously achieved profit margins by adopting an increased risk tolerance by investing in higher yield instruments. Still, others have either made de novo entries into, and subsequently exits from, various product lines or the entire insurance marketplace.

Since 1979, the overall asset distribution for the industry has not dramatically changed. In fact, bonds which comprised 44.7 percent and mortgages which represented 27.1 percent of total industry assets during 1979, accounted for 49.9 percent and 19.3 percent, respectively, during 1989 (exhibit 6). What is evident, however, are the general changes in the overall risk profile of investments within the broader asset classifications held by life insurers. From our perspective, the resulting deterioration in asset quality has been largely attributable to the response by certain carriers to competitive pressures by investing in higher yielding fixed-income securities. In addition, the reduced asset quality reflects a decline in the previously escalated values of commercial real estate properties, and the impact which this scenario has had on industrywide mortgage holdings—which have historically been proven as relatively predictable investments. Insurance companies have typically diversified their mortgage loans geographically and limited their investments to fully leased commercial properties. Moreover, the majority of companies participating in the mortgage markets maintain well seasoned portfolios, in which the market value of investments (although deflated over the past 2 years) significantly exceeds the outstanding loan balances.

At the close of 1989, 6.7 percent of total life/health carriers, which maintain the greatest exposure to less-than-investment grade bonds, accounted for nearly 76 percent of the total bonds in this category, and 6.7 percent of all life/health companies, which have the greatest exposure to nonperforming mortgages, represent over 84 percent of this respective total. Those carriers which adopted an aggressive investment strategy, generally reflected their higher returns in the rates credited or premiums charged to policyholders. In many cases, companies took into account the additional investment risk assumed by including such elements in their target profit margins. The transition of insurance from solely a method of protection to a vehicle for both protection and investment by companies and individuals is an example of the fundamental economic concept regarding the trade-off between risk and return.

It is our opinion that companies which have chosen to participate in more speculative investment vehicles, which have not maintained an adequate capitalization level to compensate for an added element of investment risk, have placed themselves in the greatest jeopardy of long-term survival in a very competitive marketplace. For our rating purposes, we feel that it is inappropriate to view solely a specific ratio of less-than-investment grade bonds or nonperforming mortgages without regard to an individual carriers insurance risk profile, overall liquidity posture, cash-flow position, and risk adjusted capitalization level.

The investment structure of life/health insurers, which includes phased maturity schedules, funds obligations of corresponding durations. As a result, companies typically hold investments to match the duration of their liabilities. In most cases, companies generate substantial positive cash-flows which provide further insulation from the need to dispose of long-term assets due to short-term fluctuations in the values of investments resulting from changes in interest rates or economic cycles (exhibit 7).

Although the A.M. Best Co. has not yet completed its solvency study of life health insurers (as such, our information is preliminary at this point in time), our records indicate that insurance company failures have not been directly related to current issues such as less than-investment-grade bonds or nonperforming mortgage and real estate holdings. While specific carriers have recently experienced a significant strain from current industry and economic conditions, life/health insolvencies over the past 10 years have largely been tied to mismanagement, excessive growth, inadequate underwriting practices, questionable reinsurance activities, affiliate reinsurance transactions, significant changes in operations and fraud.

Over the past 10 years, approximately 91 percent of the life/health companies which were declared insolvent did not qualify for the assignment of an alphabetical Best's Rating or did not file their annual statement with the A.M. Best Co. at the time of failure. In fact, nearly 88 percent of the life/health companies declared insolvent since the close of 1980, did not qualify for an alphabetical Best's Rating or did not file their financial statements with the A.M. Best Co. within 3 years of insolvency. A point worth noting is that, no company has ever been declared insolvent which carried our highest rating of A+, and only six carriers which were declared insolvent since the close of 1980 were assigned a Best's Rating of B or above. It is our opinion that, in the case of virtually all insolvencies involving alphabetically rated carriers, events within these companies were taking place in such a manner and at such a pace that detection and prevention of these specific cases became exceedingly difficult for anyone involved. From a size standpoint, our preliminary indications are that the median surplus and premium levels of insolvent life/health carriers was approximately $5.4 million and $1.8 million, respectively. Nearly one-half of companies declared insolvent were engaged in accident and health lines of business—which are inherently riskier than traditional life and annuity lines—and approximately one-third of insolvencies were concentrated in three states. (See attachments 1–3).

Competitive pressures within the industry, along with external pressures, are unlikely to diminish in the near future. Consequently, an industrywide movement by carriers to refocus their operations to better adapt to the inherent changes in today's marketplace is underway. It has been our experience through discussions with the executive managements of companies throughout the industry that increased efforts to concentrate on the fundamentals of expense and production control, realistic pricing and policy crediting strategies, asset/liability management, balance sheet quality and surplus adequacy are, by necessity, the management priorities going forward into the 1990's. Unfortunately, as in most competitive environments, not all participants will recognize rapid changes within the industry by responding in a timely or adequate manner. No system of solvency management can rely on financial monitoring alone, a qualitative review of an insurance company and its management is essential, and that is why the A.M. Best Co. meets with the majority of companies we follow each year.

Although we do not expect the frequency of industry insolvencies to dramatically escalate from recent levels in the near-term, it is our opinion that a strengthened system of insurance regulation in order to increase the detection and prevention of insolvency and preserve the relative financial strength of the industry in the future would include some of the following features: (We will develop a more comprehensive list of recommendations in our formal solvency study to be issued in a few months).

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Exhibit 1

Net Income After FIT

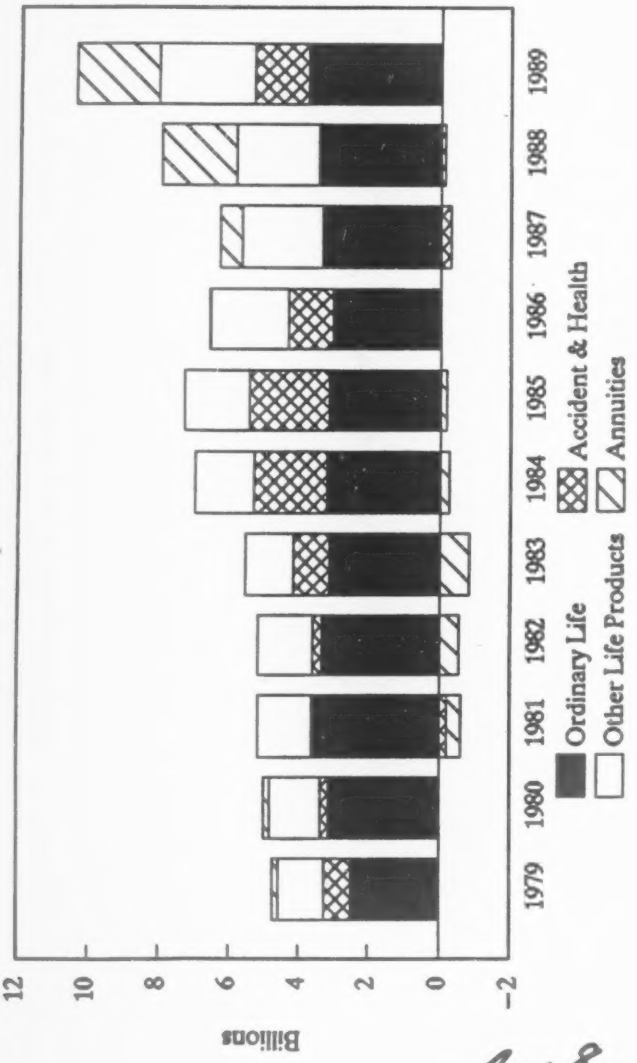


Exhibit 2

Growth in Industry Liabilities

vs. C&S/Liabilities

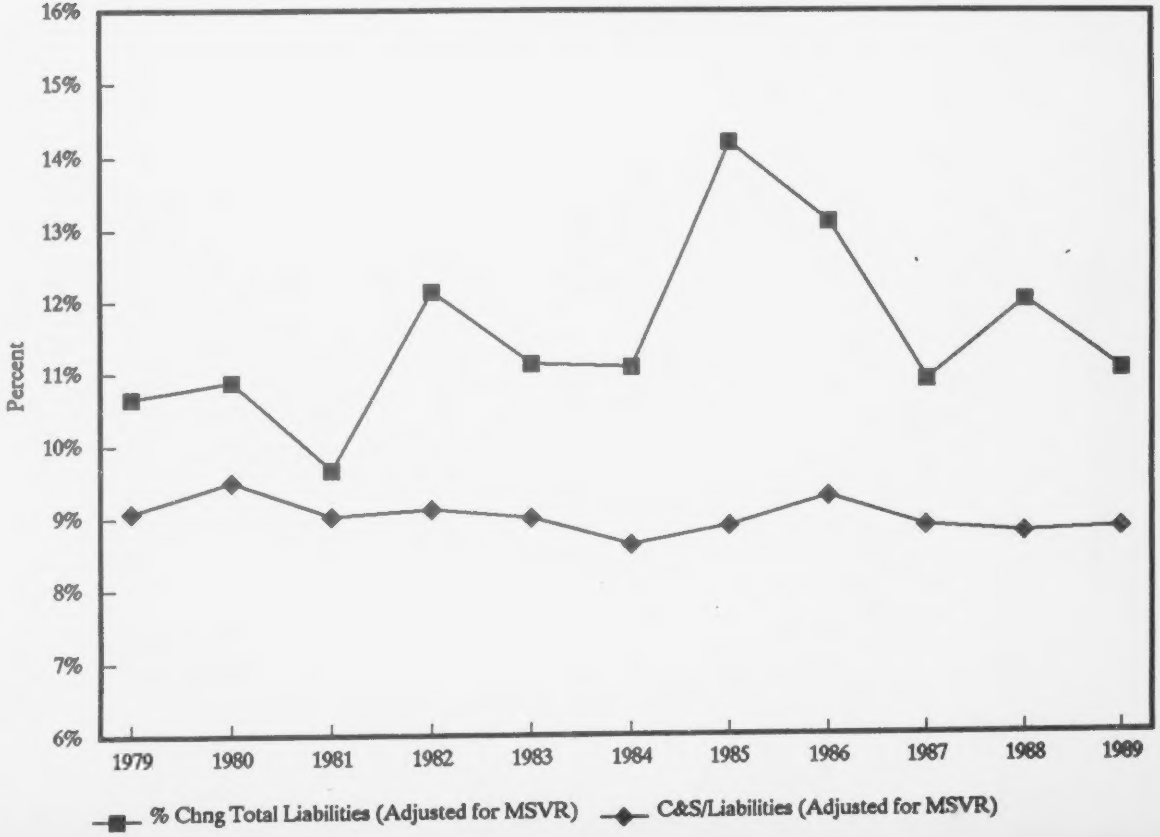


Exhibit 3 A

Net Premiums By Line Of Business

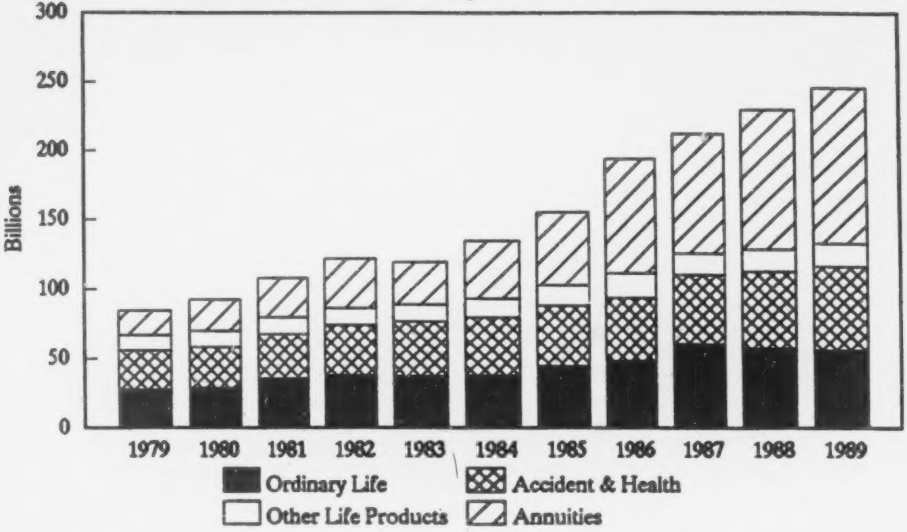


Exhibit 3 B

Return on Net Premiums

Ordinary Life vs. All Lines

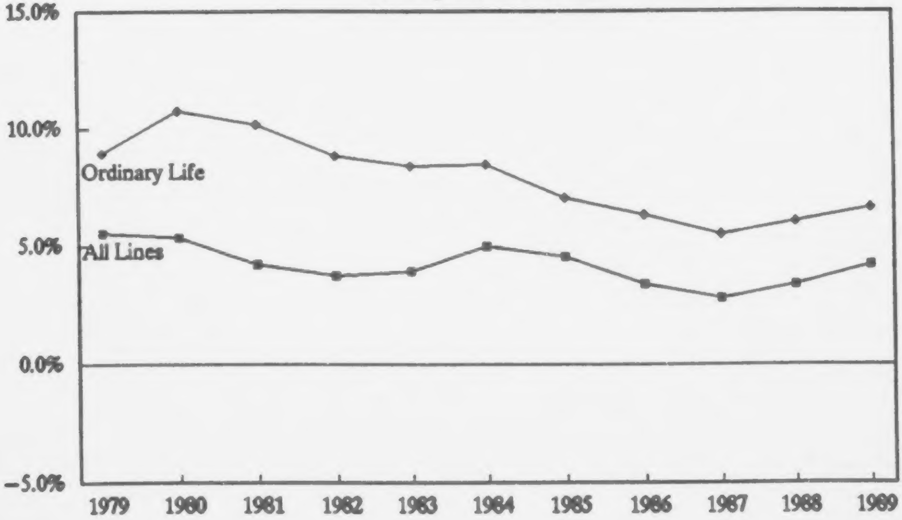
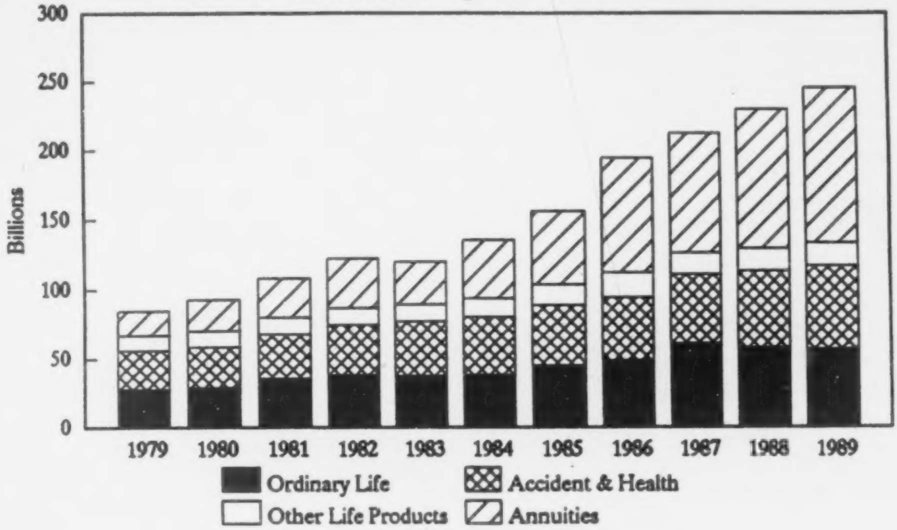
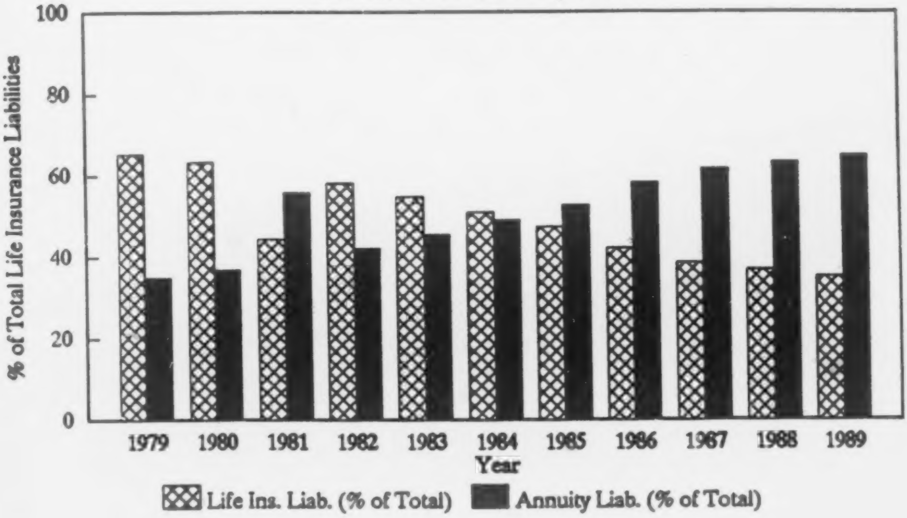


Exhibit 4A



Net Premiums By Line Of Business

Exhibit 4 B



Total Industry

Life Insurance and Annuity Liabilities

Exhibit 4 C

Return on Net Premiums

Annuities vs. All Lines

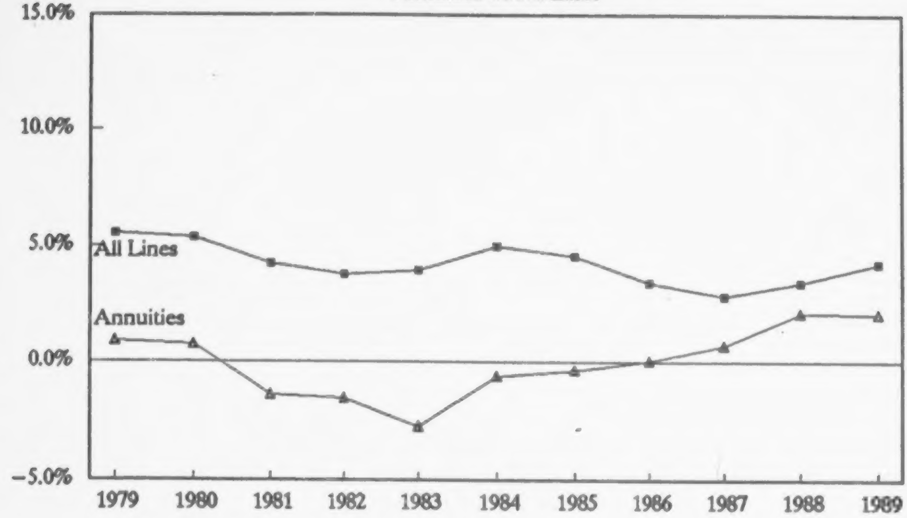


Exhibit 5

Return on Total Revenues

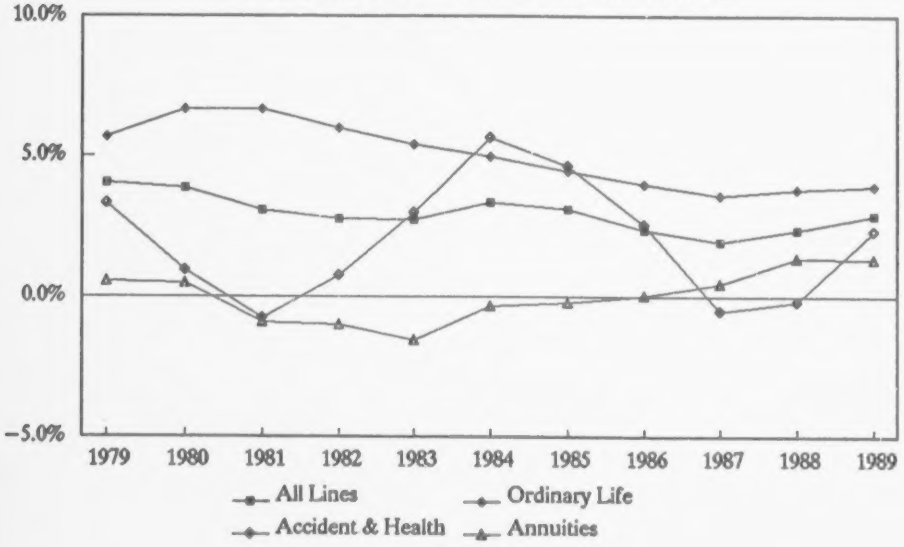


Exhibit 6

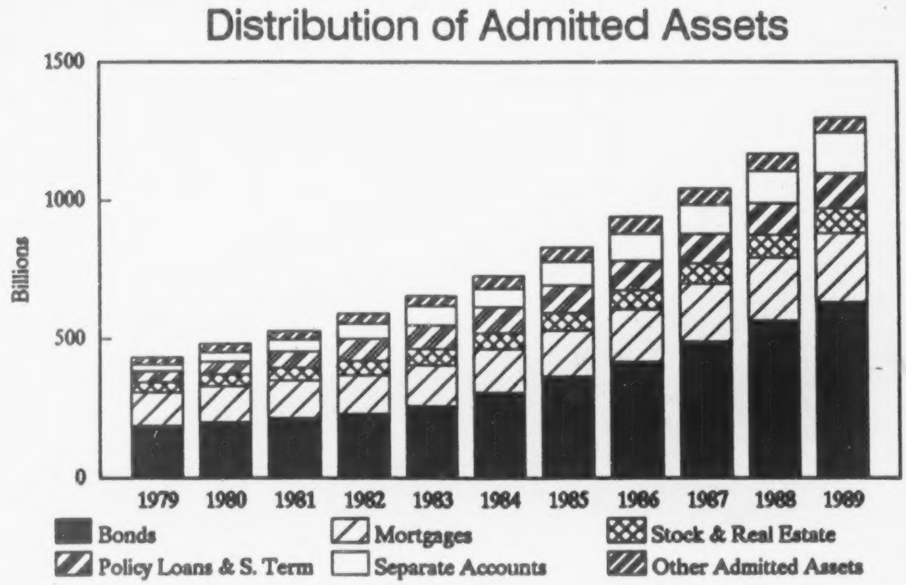
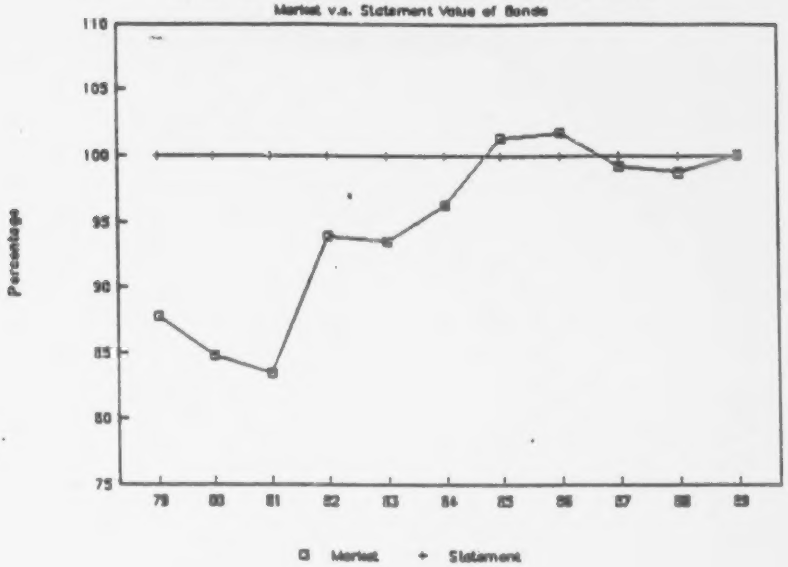
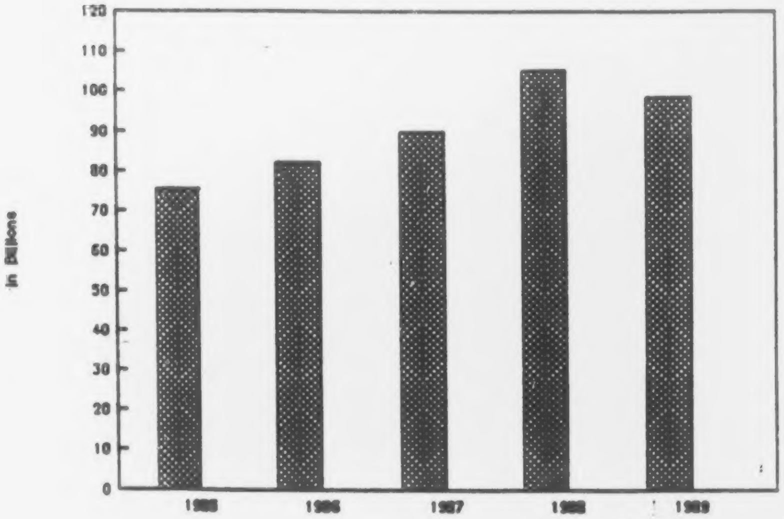

Distribution of Admitted Assets
1500
1000
500
0
Billions
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
Bonds
Mortgages
Stock & Real Estate
Policy Loans & S. Term
Separate Accounts
Other Admitted Assets

Exhibit 7



LIFE & HEALTH INDUSTRY MEDIANS

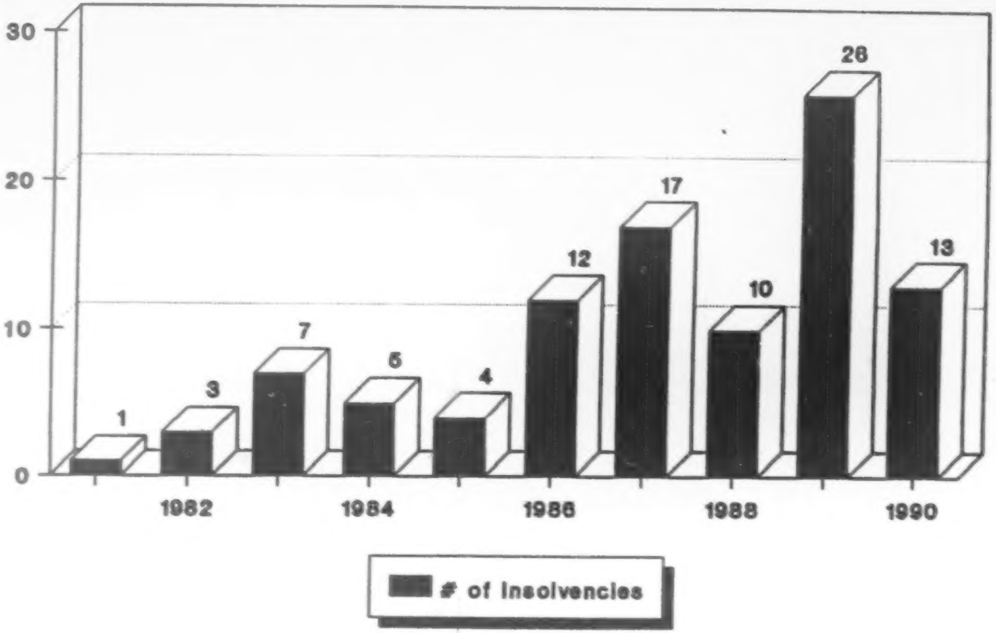
Market v.s. Statement Value of Bonds



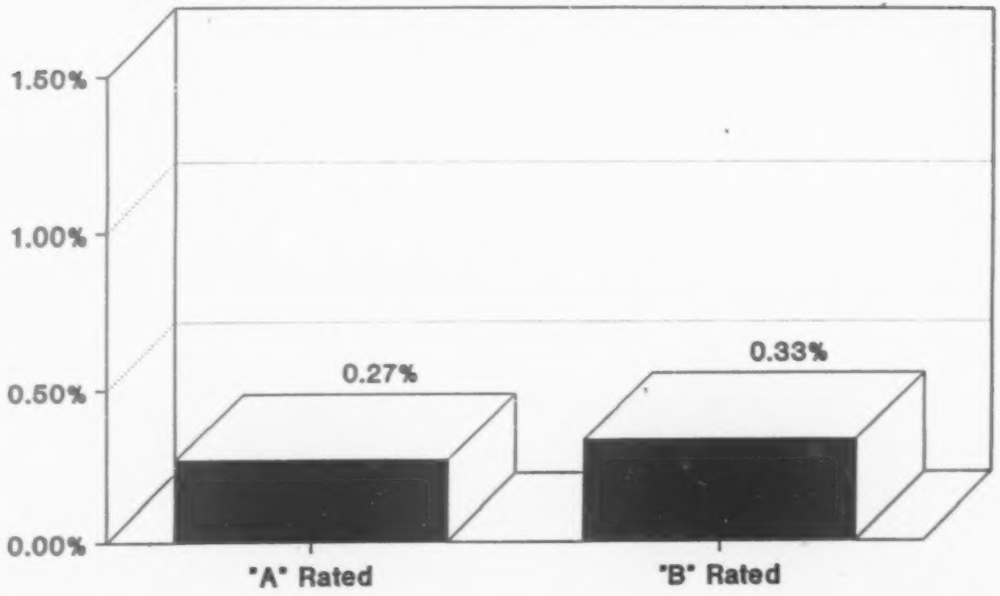
Net Cash From Operations

Attachment 1

Annual Number of L/H Insolvencies
Years 1981 - 1990



Attachment 2

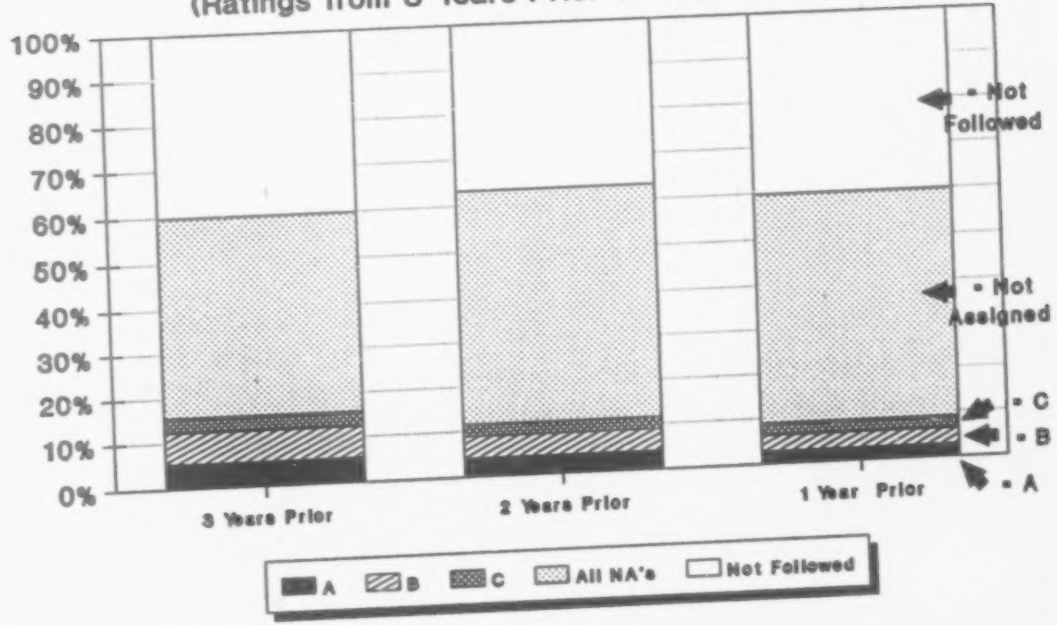


"A" and "B" Rated Companies
that have failed over the last 10 years
as a % of the Total Companies A.M. Best follows

Attachment 3

A profile of Best's Ratings of All Insolvencies

(Ratings from 3 Years Prior to Year Insolvent)

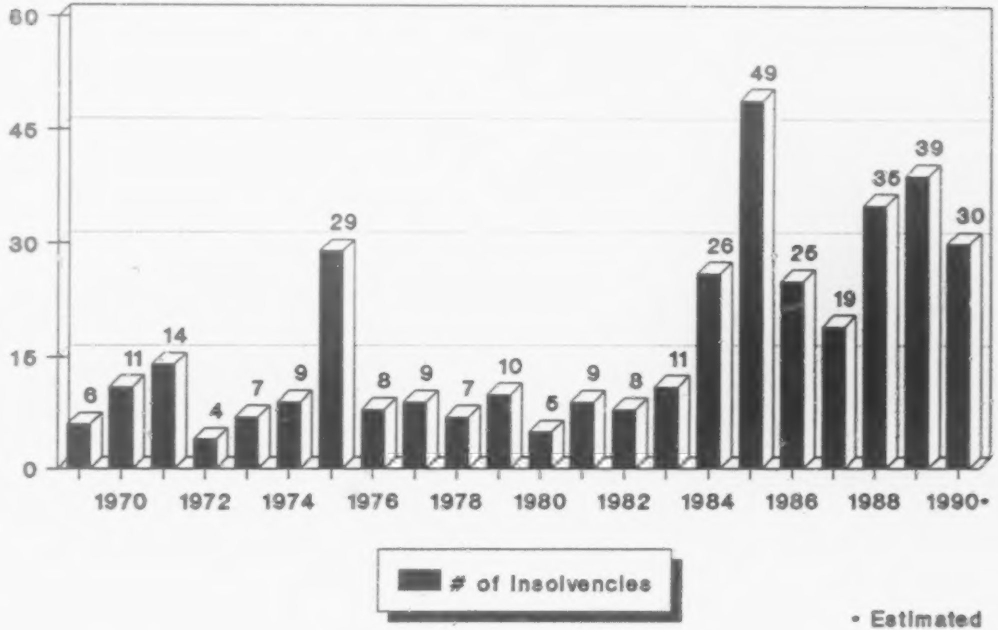


• Preliminary Data

CHART #1

Annual Number of P/C Insolvencies

Years 1969 - 1990



• Estimated

CHART #2

A profile of Best's Ratings of All Insolvencies

(Ratings from 3 Years Prior to Year Insolvent)

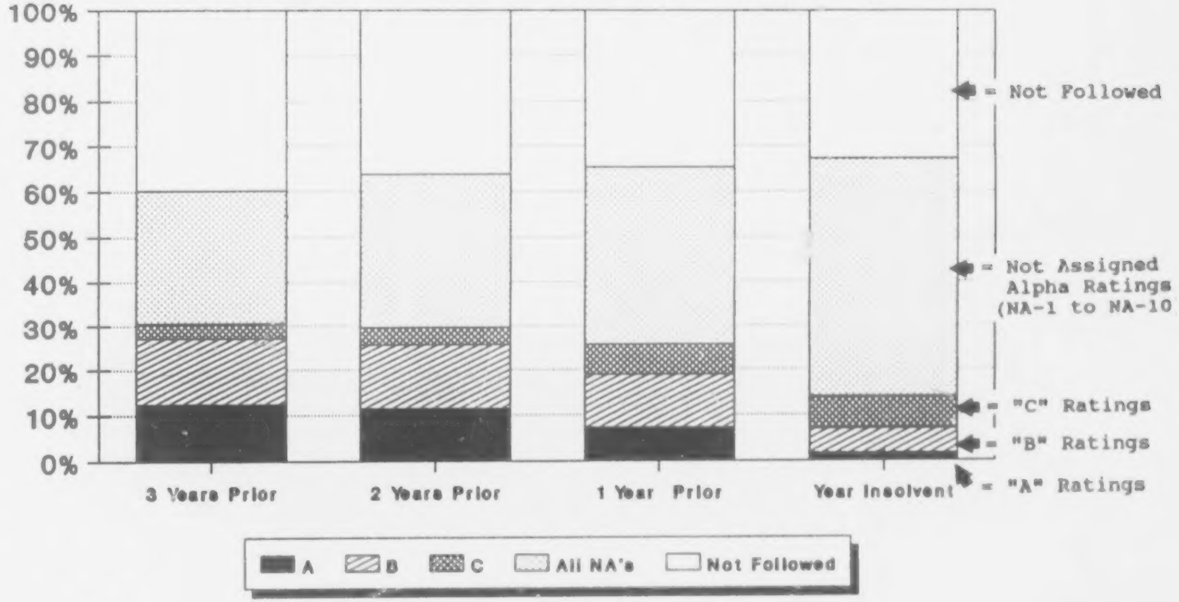


TABLE 1

STATES RANKED BY P&C ASSESSMENTS, 1987-1989

STATE	TOTAL TO 1989	1987-1989
CALIFORNIA	924,171,886	643,725,517
FLORIDA	375,103,546	162,218,047
TEXAS	192,852,274	142,411,000
ILLINOIS	163,749,601	88,802,524
CONNECTICUT	94,436,252	86,378,028
MASSACHUSETTS	78,609,930	81,126,897
MICHIGAN	139,503,636	80,954,202
LOUISIANA	104,803,871	72,088,297
PENNSYLVANIA	141,804,226	65,033,978
MINNESOTA	127,028,224	62,287,000
OKLAHOMA	69,223,950	33,924,200
DELAWARE	37,726,924	31,398,124
OHIO	61,531,509	31,250,000
ALABAMA	41,522,536	28,112,192
MARYLAND	35,571,085	28,000,000
MISSISSIPPI	37,197,173	27,440,045
MAINE	29,817,187	26,996,765
GEORGIA	53,492,288	24,870,438
COLORADO	35,201,311	21,320,465
IOWA	34,638,264	20,930,000
MISSOURI	21,431,038	20,057,749
WASHINGTON	28,021,037	19,989,898
ARIZONA	41,261,200	19,440,000
WISCONSIN	33,008,054	18,009,000
TENNESSEE	19,667,327	13,520,932
MONTANA	28,605,030	13,300,401
VIRGINIA	21,796,025	12,483,366
SOUTH CAROLINA	22,137,890	11,827,570
RHODE ISLAND	12,852,823	10,508,229
WEST VIRGINIA	14,102,223	10,000,000
HAWAII	34,750,648	9,725,325
NEW HAMPSHIRE	15,055,838	9,638,746
NEVADA	17,806,006	9,484,844
NEBRASKA	16,677,004	9,377,086
OREGON	17,154,071	8,690,289
KANSAS	16,997,597	7,317,297
ALASKA	10,842,897	6,774,587
KENTUCKY	20,678,766	5,727,553
PUERTO RICO	31,780,290	5,369,780
NEW MEXICO	13,158,076	4,781,566
DISTRICT OF COLUMBIA	6,386,964	4,582,268
INDIANA	9,851,682	4,450,000
ARKANSAS	17,329,731	3,951,140
IDAHO	8,340,643	3,759,060
NORTH CAROLINA	15,104,337	2,534,052
SOUTH DAKOTA	5,298,588	2,353,124
VERMONT	5,977,545	2,231,024
NORTH DAKOTA	4,319,795	802,841
WYOMING	2,452,550	350,000
UTAH	7,173,881	0
NEW JERSEY	11,418,500	0
TOTAL	3,298,005,229	2,010,385,446

SOURCES: National Conference of Insurance Guaranty Funds, individual state guaranty funds

TABLE 2

STATES RANKED BY L/H ASSESSMENTS, 1987-1989

STATE	TOTAL TO 1989	1987-1989
TEXAS	151,151,105	117,511,105
FLORIDA	58,523,656	29,263,123
WASHINGTON	33,891,941	25,400,621
ILLINOIS	39,155,551	20,912,356
OREGON	19,969,434	19,969,434
OKLAHOMA	24,460,021	13,996,201
ARIZONA	25,691,196	11,953,421
MONTANA	11,315,186	11,173,255
KENTUCKY	11,433,299	10,748,889
INDIANA	22,035,495	10,547,295
MINNESOTA	10,657,000	9,450,000
GEORGIA	8,677,550	8,438,350
MISSOURI	8,014,758	8,014,758
NORTH CAROLINA	7,768,772	6,877,103
PENNSYLVANIA	8,732,200	6,588,200
ALABAMA	7,995,000	6,037,000
WISCONSIN	15,826,626	4,890,626
MISSISSIPPI	3,770,100	3,770,100
NEBRASKA	2,483,170	1,703,600
VIRGINIA	1,838,106	1,602,056
IDAHO	2,950,017	1,406,027
WEST VIRGINIA	2,360,000	1,050,000
IOWA	1,002,250	1,002,250
NEVADA	828,446	828,446
KANSAS	3,648,034	812,137
SOUTH CAROLINA	1,597,630	783,719
MARYLAND	2,908,606	634,148
UTAH	1,480,686	445,050
DELAWARE	7,424,332	350,000
CONNECTICUT	3,778,384	264,436
VERMONT	2,257,372	257,000
TENNESSEE	190,000	190,000
NEW MEXICO	4,782,523	117,531
HAWAII	1,221,086	97,250
NORTH DAKOTA	116,852	83,252
NEW HAMPSHIRE	131,700	66,000
RHODE ISLAND	69,700	5,200
PUERTO RICO	733,795	0
MAINE	25,000	0
MASSACHUSETTS	0	0
NEW YORK	90,000	(160,000)
MICHIGAN	3,236,020	(706,500)
TOTAL	514,222,599	336,373,439

SOURCES: National Organization of Life and Health Guaranty Associations, individual State guaranty associations

TABLE 3

STATES RANKED BY TRIENNIAL RATE OF INCREASE IN P&C FUND ASSESSMENTS, 1984-1989

(1982-1984=$1.00)

STATE	1984-1986	1987-1989	PERCENT CHANGE
RHODE ISLAND	424,255	8,844,880	1984.80%
CONNECTICUT	7,363,915	72,610,276	886.03%
MAINE	2,532,413	22,309,219	780.95%
DELAWARE	5,568,455	26,091,846	368.57%
MARYLAND	5,160,413	23,656,000	358.41%
TEXAS	36,820,000	119,599,826	224.82%
WASHINGTON	5,355,060	17,217,110	221.51%
CALIFORNIA	169,746,242	539,996,928	218.12%
MISSISSIPPI	8,253,049	22,485,836	172.45%
WEST VIRGINIA	3,235,950	8,800,000	171.94%
DISTRICT OF COLUMBIA	1,530,814	3,831,389	150.28%
LOUISIANA	24,931,186	60,814,131	143.93%
TENNESSEE	5,235,358	11,397,169	117.70%
ALASKA	2,838,529	5,854,444	106.25%
ALABAMA	12,314,432	23,627,100	91.87%
NEW HAMPSHIRE	4,732,868	8,006,075	69.16%
MICHIGAN	42,120,329	68,773,597	63.28%
IOWA	10,959,605	17,566,350	60.28%
COLORADO	11,251,443	17,927,490	59.34%
NEBRASKA	5,568,541	7,612,002	36.70%
VIRGINIA	7,612,956	10,266,224	34.85%
WISCONSIN	11,467,596	15,331,304	33.69%
ILLINOIS	57,823,232	75,726,394	30.96%
PENNSYLVANIA	45,691,797	55,162,494	20.73%
NEVADA	7,001,876	8,118,393	15.95%
OREGON	6,395,378	7,379,899	15.39%
FLORIDA	126,238,088	140,166,631	11.03%
SOUTH CAROLINA	9,125,703	9,793,582	7.32%
OHIO	24,681,050	26,456,000	7.19%
MINNESOTA	52,775,152	53,605,054	1.57%
ARIZONA	16,994,342	16,667,240	-1.92%
OKLAHOMA	30,986,858	28,603,067	-7.69%
GEORGIA	23,366,141	21,040,391	-9.95%
IDAHO	3,567,356	3,145,843	-11.82%
MONTANA	13,330,059	11,452,353	-14.09%
KANSAS	7,799,609	6,387,179	-18.11%
INDIANA	4,773,818	3,815,700	-20.07%
SOUTH DAKOTA	2,559,470	1,990,743	-22.22%
NEW MEXICO	6,840,385	3,863,505	-43.52%
VERMONT	3,425,908	1,826,684	-46.68%
KENTUCKY	11,363,729	4,859,202	-57.24%
HAWAII	22,367,430	8,558,286	-61.74%
ARKANSAS	11,895,570	3,323,682	-72.06%
NORTH DAKOTA	3,203,269	706,500	-77.94%
NORTH CAROLINA	11,641,993	2,132,866	-81.68%
WYOMING	1,850,162	282,800	-84.71%
UTAH	6,639,452	0	-100.00%
PUERTO RICO	(192,161)	4,725,406	-2559.08%
MISSOURI	0	17,073,812	NA
NEW JERSEY	NA	NA	NA
MASSACHUSETTS	0	67,934,689	NA
TOTAL	897,169,071	1,697,417,591	89.20%

SOURCES: National Conference of Insurance Guaranty Funds, individual state guaranty funds

TABLE 4

STATES RANKED BY TRIENNIAL RATE OF CHANGE IN L/H FUND ASSESSMENTS, 1984-1989

(1982-1984=$1.00)

STATE	1984-1986	1987-1989	PERCENT CHANGE
MONTANA	65,736	9,635,302	14557.57%
WASHINGTON	579,034	21,340,458	3585.53%
NEBRASKA	49,138	1,431,883	2814.00%
WISCONSIN	162,008	4,114,284	2439.56%
MINNESOTA	341,617	8,110,300	2274.09%
KENTUCKY	505,020	9,138,820	1709.60%
NORTH CAROLINA	415,747	6,006,027	1344.64%
IDAHO	122,134	1,237,304	913.07%
TEXAS	15,833,000	98,003,629	518.98%
KANSAS	177,168	680,831	284.29%
ALABAMA	1,412,065	5,225,520	270.06%
INDIANA	2,661,510	9,161,720	244.23%
WEST VIRGINIA	288,300	888,300	208.12%
PENNSYLVANIA	1,957,472	5,589,778	185.56%
SOUTH CAROLINA	348,034	668,073	91.96%
UTAH	216,564	378,860	74.94%
FLORIDA	18,966,595	24,428,625	28.80%
OKLAHOMA	9,812,419	11,941,667	21.70%
NEW HAMPSHIRE	55,680	58,080	4.31%
ARIZONA	11,123,008	9,658,364	-13.17%
CONNECTICUT	284,211	218,183	-23.23%
VERMONT	966,878	207,656	-78.52%
HAWAII	1,052,123	80,734	-92.33%
RHODE ISLAND	58,889	4,491	-92.37%
DELAWARE	4,955,570	282,800	-94.29%
NEW MEXICO	2,604,366	104,180	-96.00%
NEW YORK	(6,436,000)	(129,280)	NA
PUERTO RICO	625,689	0	NA
MAINE	23,200	0	NA
MICHIGAN	3,494,971	(570,852)	NA
ILLINOIS	(7,306,616)	16,731,557	NA
NEVADA	0	684,408	NA
VIRGINIA	0	1,406,587	NA
MASSACHUSETTS	0	0	NA
TENNESSEE	0	153,520	NA
MARYLAND	0	551,613	NA
MISSOURI	0	6,513,932	NA
IOWA	0	833,447	NA
OREGON	0	16,239,545	NA
MISSISSIPPI	0	3,126,265	NA
NORTH DAKOTA	0	72,699	NA
GEORGIA	0	7,272,190	NA
TOTAL	65,415,529	281,481,499	330.30%

SOURCES: National Organization of Life and Health Insurance Guaranty Associations, individual state guaranty associations

COMPARISON OF STATE PROPERTY & CASUALTY GUARANTY FUND LAWS

STATE	EFFECTIVE DATE	REFUND OF UNEARNED PREMIUMS	MAXIMUM COVERED CLAIM	NET WORTH PROVISION	DEDUCTIBLE PER CLAIM	RECOUPMENT PROVISION	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	EARLY ACCESS & PRIORITY IN LIQUIDATION	SEPARATE ACCOUNTS	TERMINATION PROVISION
AL	01/01/81	Yes	$150,000*	No	$100*	Premium Tax Offsets	1%	Yes	WC, Auto, All others	No
AK	08/06/70	Yes	$300,000*	No	$100*	Rate Recoupment	2%	No	WC, Auto, All others	Yes
AZ	08/27/77	Yes	$100,000(1)	No	$100	Premium Tax Offset	1%	Yes	Auto, All others	No
AR	03/30/77	Yes, up to $25,000/policy	$300,000#	No	None	Premium Tax Offset	2%	No(2)	None	No
CA	09/02/69	Yes	$500,000* #	No	$100*	Policy Surcharge	1% On any single Insolvency	Yes	WC, Auto, All others	No
CO	07/01/71	Yes	$100,000*	Yes(3)	$100*	Rate Recoupment	1%	Yes	WC, Auto, All others	Yes
CT	10/01/71	Yes	1/2 of unearned, $1,000 max(4)	Yes(5)	$100 in case of WC	Rate Recoupment	2%	Yes	WC, Auto, All others	No
DE	07/01/70	Yes	$300,000*	No	$100*	Premium Tax Offset	2%	Yes	None	No
DC	08/14/73	Yes	$300,000*	No	$100*	Rate Recoupment	2%	No	WC, Auto, All others	Yes
FL	10/01/70	Yes	$300,000*	No	$100*	Premium Tax Offset(6)	2%	Yes	WC, Auto (liab. & phys.), All others	Yes
GA	07/01/70	Yes	$100,000* #	Yes(7)	None(8)	Rate Recoupment	2%	No	WC, Auto, All others	Yes
HI	05/25/71	Yes	$300,000* #	No	None	Policy Surcharge	2%	Yes	None	No
ID	05/06/70	Yes	$300,000*	No	$100*	Rate Recoupment	1%	Yes	WC, Auto, All others	Yes
IL	07/21/71	Yes, up to $10,000	$300,000* #	Yes(9)	$100 on Unearned Premiums Only	No(10)	1%	Yes	WC, Auto, All others	No

* Except for Workmen's Compensation
# Punitive damages not covered

COMPARISON OF STATE PROPERTY & CASUALTY GUARANTY FUND LAWS

STATE	EFFECTIVE DATE	REFUND OF UNEARNED PREMIUMS	MAXIMUM COVERED CLAIM	NET WORTH PROVISION	DEDUCTIBLE PER CLAIM	RECOUPMENT PROVISION	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	EARLY ACCESS & PRIORITY IN LIQUIDATION	SEPARATE ACCOUNTS	TERMINATION PROVISION
IN	01/01/72	Yes, limits(11)	$100,000/claim (12)	Yes(13)	None	Premium Tax Offsets	1%	Yes	WC, Auto All others, no gen	Yes
IA	07/01/70	Yes(14)	$300,000*(15)	No	$100	Rate Recoupment	2%	Yes	None	No
KS	03/27/91	Yes	$300,000*	No	$100*	Premium Tax Offset	2%	Yes	None	Yes
KY	06/15/72	Yes	$100,000	No	None	Rate Recoupment	1%	Yes	None	No
LA	09/01/70	Yes, up to $10,000/Policy	$150,000*	No	$100*	Premium Tax Offset	1%	Yes	None	No
ME	05/09/70	Yes, not to Exceed $100,000	$300,000*	No	None	Rate Recoupment	1%	Immediate Access	WC, Auto(16) All others	Yes
MD	01/07/71	Yes	$300,000* (17)	No	$100	Rate Recoupment	2%	Yes	WC, Auto, Title All others	Yes
MA	01/01/71	Yes	$300,000	No	None	Rate Recoupment	2%	Yes	None	Yes
MI	08/11/69	Yes, up to $500 w/COLA	(18)*	Yes(19)	$10	Rate Recoupment	1%	Yes	WC, Auto, Title (20) All others	No
MN	07/01/71	Yes	$300,000*	No	$100*(21)	Policy Surcharge	2%	Early Access	WC, Auto, (22), All others	Yes*
MS	04/06/70	Yes	$300,000*	No	$100*	Rate Recoupment	1%	Early Access	None	No
MO	09/13/71	Yes, up to $10,000	$300,000*	No	$200	Premium Tax Offset	1%	No	WC, Auto, (23), All others	No
MT	07/01/77	Yes	$300,000*	No	$100*	Rate Recoupment	2%	Yes	None	No
NE	05/26/71	Yes, up to $10,000	$300,000*	No	$100*	Premium Tax Offset	1%	Yes	WC, Auto, All others	No
NV	05/05/71	No	$300,000	No	None	Premium Tax Offset	2%	Yes	None	No
NH	05/04/70	Yes	$300,000*	No	$50	Rate Recoupment	2%	Yes	WC, Auto, All others	No

* Except for Workman's Compensation
# Punitive damages not covered

COMPARISON OF STATE PROPERTY & CASUALTY GUARANTY FUND LAWS

STATE	EFFECTIVE DATE	REFUND OF UNEARNED PREMIUMS	MAXIMUM COVERED CLAIM	NET WORTH PROVISION	DEDUCTIBLE PER CLAIM	RECOUPMENT PROVISION	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	EARLY ACCESS & PRIORITY IN LIQUIDATION	SEPARATE ACCOUNTS	TERMINATION PROVISION
NJ	04/11/74	Yes	$300,000(24)	No	None	Policy Surcharge	2%	Early Access	None	Yes
NM	04/04/73	Yes	$100,000*	No	25	Rate Recoupment	2%	Yes	WC, Auto, All others	Yes
NC	06/25/71	Yes	$300,000	No	None(25)	Rate Recoupment	2%	Priority	Auto, All others	Yes
ND	07/01/71	Yes	$300,000	No	$100	Rate Recoupment	2%	Yes	None	No
OH	09/04/70	Yes	$300,000	No	None	Rate Recoupment	1-1/2%	Yes	Auto, All others	Yes
OK	06/27/80	Yes, Up to $10,000/policy	$150,000* #	None	Yes	Rate Recoupment	(26)	Yes	WC, Auto, All others	No
OR	09/09/71	Yes	$300,000*	No	None	Premium Tax Offset	2%	Early Access Only	None	No
PA	11/25/70	Yes	$300,000	No	$100	Rate Recoupment	2%	Yes	Auto, All others	No
PR	07/03/74	Yes	$150,000	No	$50	Rate Recoupment	2%	Yes	Auto, Casualty other than auto All others	No
RI	05/07/70	Yes, up to $10,000	$300,000* #	No	1/12 1 years prem for unearned premium*	Rate Recoupment	2%	Yes	WC, Auto, All others	Yes
SC	06/25/71	Yes, $100 Deductible	$300,000*	No	$250*	Rate Recoupment	1%	Yes	WC, Auto, Home/ Farm multi peril, All others	Yes
SD	07/01/70	Yes	$300,000*	No	$100*	Rate Recoupment	1% Admin. Assess<$50/Yr	Yes	WC, Auto, All others	No
TN	07/01/71	Yes(27)	$100,000*	No	$250*	Premium Tax Offset	1%	No	WC, All others Not gen damages	No

* Except for Workmen's Compensation
# Punitive damages not covered

COMPARISON OF STATE PROPERTY & CASUALTY GUARANTY FUND LAWS

STATE	EFFECTIVE DATE	REFUND OF UNEARNED PREMIUMS	MAXIMUM COVERED CLAIM	NET WORTH PROVISION	DEDUCTIBLE PER CLAIM	RECOUPMENT PROVISION	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	EARLY ACCESS & PRIORITY IN LIQUIDATION	SEPARATE ACCOUNTS	TERMINATION PROVISION
TX	05/25/71	Yes, 75% up to $1,000	$100,000*	No	25% unearned prem. None on all others	Premium Tax Offset	2%	No(28)	Admin, WC, Auto All others	No
UT	05/11/71	No	$300,000* #	Yes(29)	$100*	Premium Tax Offset	2%	Yes	WC, Auto, All others	Yes
VT	07/01/70	Yes, $25 Deductible	$300,000*	No	None	Rate Recoupment	2%	Yes	WC, Auto, All others	No
VA	06/25/70	Yes	$300,000*#	Yes(30)	$50 for Unearned Prems	Premium tax Offset	2%	Yes	WC, Auto, All others	Yes
WA	05/21/71	Yes	$300,000	No	$100	Premium Tax Offset	2%	Yes	Auto, All others	Yes
WV	05/12/70	Yes	$300,000	No	$100	Rate Recoupment	2%	Yes	Auto, All others	Yes
WI	06/22/69	No	$300,000*	Yes(31)	$200	Rate Recoupment (32)	2%	Early access (modified)	Life, Annuity, Disab, All other, Admin Acct	No
WY	02/27/71	No	$100,000*	No	$100*	Rate Recoupment	1%	Reciprocal Priority (33)	None	No

SOURCES: National Conference of Insurance Guaranty Funds, phone interviews.

* Except for Workmen's Compensation
# Punitive damages not covered

NOTES TO PROPERTY & CASUALTY FUND LAWS CHART

1 **AZ** $100,000 per claim except no limit to unearned premiums over $25.

2 **AR** The receiver pays all claims. The guaranty association does not process or pay claims.

3 **CO** $100,000 except in case of a workman's compensation claim. The act does not apply to claimants with net worth exceeding $50 million as of 12/31/90. (See Michigan, note 19)

4 **CT** One-half of unearned premiums subject to a maximum of $1,000 per policy, $300,000 per claim except for workman's compensation claims.

5 **CT** The fund can recover from the insured any liability payments made on the insured's behalf if the insured's net worth exceeds $50 million. (See Michigan, note 19)

6 **FL** Credit against income tax for domestics only.

7 **GA** Claimants with a net worth greater than $3 million are not covered. (See Michigan, note 19)

8 **GA** The guaranty fund need not pay any claim under $25.

9 **IL** Also, no claims are covered for insured parties with a net worth exceeding $50 million. The fund can recover liability payments made on the insured's behalf if the insured's net worth exceeds $50 million.

10 **IL** Illinois is the only guaranty association which does not contain a recoupment provision. According to John G. Smith, former counsel to the Illinois Guaranty Association, insurers recognize assessment costs as an operating expense. Mr. Smith stated that assessment expense is not formally included in the rate determination formula, although the expense may have a slight effect on rates.

11 **IN** Refund of unearned premiums are limited to the lesser of 80% or $650 per month up to twelve months.

12 **IN** $100,000 per claim is covered with a maximum of $300,000 per occurrence.

13 **IN** Claimants with net worths exceeding $5 million and third party claims against insureds with net worths exceeding $50 million are not covered.

14 **IA** Claims for unearned premiums calculated in retrospective or experience-rated plan are not refunded nor are premiums subject to adjustment after the date of liquidation.

15 **IA** $300,000 per claim is covered for damages arising out of any one accident regardless of the number of persons making claims, except in the case of workman's compensation.

16 **ME** Physical damage insurance is included in the "other" category.

17 **MD** A maximum of $300,000 per $100 claim is covered, except in the case of workman's compensation. An aggregate limit of $1 million applies to the total claims paid arising under any one surety bond.

18 **MI** The maximum covered claim is that portion of any claim other than a workman's compensation claim which is in excess of 1/20 of 1% of the aggregate premiums by member insurers in MI in the preceeding year.

19 **MI** The law excludes first party claimants with a net worth greater than 1/10 of 1% of aggregate premiums. (In Borman's Inc. v. Michigan Property and Casualty Guaranty Association, the MI Supreme Court declared the net worth exclusion unconstitutional).

20 **MI** Fire, allied lines, farm owner's multiple peril, home owner's multiple peril, inland marine, earthquake and credit are included.

21 **MN** The fund provides a $100 deductible except for claims eligible for payment under the assigned claims plan or workman's compensation.

22 **MN** Township Mutuals, Fidelity and Surety.

23 **MO** Fully assessable Farmer's Mutual.

24 **NJ** The maximum claim is $75,000 in the case of medical expenses incurred as a result of personal injury sustained in an auto accident.

25 **NC** The fund need not pay a claim under $50.

26 **OK** The maximum assessment on insurers is the lesser of 2% of the insurer's net direct written premium or 1% of that insurer's policyholder surplus.

27 **TN** Only the amount of each covered claim in excess of $250 and less than $10,000 may be refunded.

28 **TX** The receiver pays all claims. The guaranty fund does not process or pay claims.

29 **UT** The fund may recover claims paid on behalf of any insured whose net worth exceeds $50 million. (See Michigan, note 19.)

30 **VA** The fund can recover third party liablity payments made on behalf of insureds whose net worth exceeds $50 million. See Michigan, note 19.)

31 **WI** Additional limits are placed on first party claims by insureds whose net worths exceed $10 million. The fund may also recover third party liability payments made on behalf of such insureds. (See Michigan, note 19.)

32 **WI** Alternative premium tax offset if a rate recoupment is not possible.

33 **WY** Priority: Immediate Access for WY Insurance Guaranty Association and other associations with immediate access provisions (reciprocal basis).

COMPARISON OF STATE LIFE/HEALTH GUARANTY FUNDS

STATE	MAXIMUM CLAIM COVERED	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	RESIDENTS ONLY COVERAGE	NO. & TYPE OF ACCOUNTS	COVERS UNALLOCATED ANNUITIES	PREMIUM TAX OFFSETS
AL	$300,000	1%	No	3: Health, Life Annuity	Not Addressed	20% for 5 Years beginning year after assessment paid
AK	$300,000	2%	Yes	2: Health, Life & Annuities with 3 subaccounts	Yes	No
AZ	$300,000	2%	No	3: Life, Health and Annuity	Not Addressed	20% for 5 years beginning year of assessment
AR	$300,000	2%	Yes	2: Health, Life & Annuities with 3 subaccounts	Yes	20% for 5 Years beginning year after assessment paid
CA	$250,000	1%	Life: Yes Health: No	Two Separate Funds: Life & Health	No	Life: No Health: No, but mandatory policy-holder surcharge
CT	$300,000	2%	Yes	2: Health, Life & Annuities with 3 subaccounts	Yes	50% in year of assessment
DE	$300,000	2%	Yes	3: Health, Life and Annuity	Not Addressed	20% for 5 Years beginning year after assessment paid
FL	$300,000	1%	Yes	3: Health, Life and Annuity	Not Addressed	10% for 10 years beginning year after assessment paid
GA	$300,000	2%	Yes	2: Health, Life & Annuities with 3 subaccounts	Yes	20% for 5 Years beginning year after assessment paid
HI	$300,000	2%	Yes	3: Health, Life and Annuity	No	20% for 5 Years beginning year after assessment paid
ID	$300,000	2%	Yes	3: Health, Life and Annuity	Not Addressed	100% any of 5 years following year assessment paid
IL	$300,000	2%	Yes	2: Health, Life & Annuities with 3 subaccounts	Yes	20% for 5 Years beginning year after assessment paid; Offset only if aggr assess exceeds $3mil
IN	$300,000	2%	Yes	3: Health, Life and Annuity	Not Addressed	20% for each year following or include in premium rates
IA	$300,000	2%	Yes	4: Health, Life Allocated Ann., Unall. Ann.(but for assmnts treated more like states with subaccounts)	Yes	20% for 5 years beginning year after assessment paid
KS	$300,000	2%	Yes	3: Health, Life Annuities	No	20% for 5 years beginning year after assessment paid

COMPARISON OF STATE LIFE/HEALTH GUARANTY FUNDS

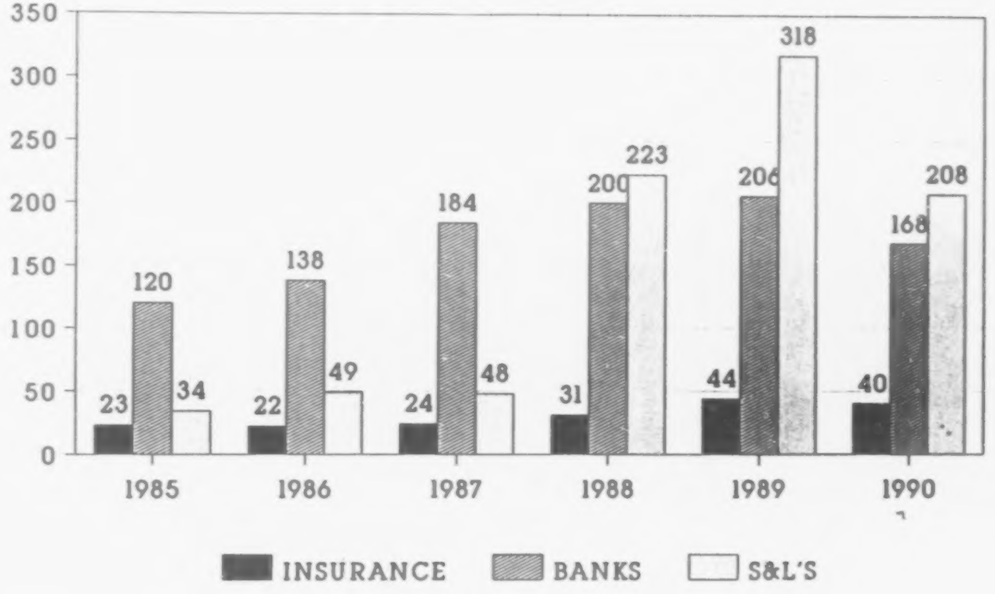
STATE	MAXIMUM CLAIM COVERED	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	RESIDENTS ONLY COVERAGE	NO. & TYPE OF ACCOUNTS	COVERS UNALLOCATED ANNUITIES	PREMIUM TAX OFFSETS
KY	$300,000	2%	Yes	3: Health, Life Annuities	No	20% for 5 years beginning year after assessment paid
ME	$300,000	2%	Yes	3: Health, Life Annuities	Not Addressed	No- recoup from premiums charged
MD	Fulfills Contractual Obligation	2%	Yes	3: Health, Life Annuities	Not Addressed	No
MA	$300,000	2%	Yes	3: Health, Life Annuities	No	10% for 5 years beg year after asst; $3 million for all insurers per year
MI	$300,000	2%	Yes	3: Health, Life Annuities w/3 subaccts; Legal expense insured	Yes	No
MN	$300,000	2%	Yes	3: Health, Life Annuities	Not Addressed	No
MS	$300,000	2%	Yes	2: Health, Life & Annuities with 3 subaccounts	Yes	25% for next 2 yrs (effective 7/1/91)
MO	$300,000	2%	Yes	3: Health, Life Annuities	No	20% for 5 years beginning year after assessment paid
MT	$300,000	2%	Yes	3: Health, Life Annuities	Not Addressed	20% for 5 years beginning year after assessment paid
NE	$300,000	2%	Yes	3: Health, Life Annuities	Not Addressed	20% for 5 years beginning year after assessment paid
NV	$300,000	2%	No	3: Health, Life Annuities	Not Addressed	20% for 5 years beginning year after assessment paid
NH	$300,000	4%	No	3: Health, Life Annuities	Not Addressed	No
NM	$300,000	2%	No	3: Health, Life Annuities	Not Addressed	No
NY	$500,000	2%	Yes	2: Health, Life Annuity & Funding Arrangement	Not Addressed	80%, formula effective when aggr assts for insrs exceed $100 million
NC	$300,000	4%	No	3: Health, Life Annuities	Not Addressed	No
ND	$300,000	2%	Yes	2: Health, Life & Annuities w/ 3 Subaccounts	Yes	20% for 5 years beginning year after assessment paid
OH	$300,000	2%	Yes	2: Health, Life & Annuities w/ 3 Subaccounts	Yes	20% for 5 years beginning year after assessment paid

COMPARISON OF STATE LIFE/HEALTH GUARANTY FUNDS

STATE	MAXIMUM CLAIM COVERED	MAXIMUM ANNUAL ASSESSMENT ON INSURERS	RESIDENTS ONLY COVERAGE	NO. & TYPE OF ACCOUNTS	COVERS UNALLOCATED ANNUITIES	PREMIUM TAX OFFSETS
OK	$300,000	2%	Yes	3: Health, Life Annuities	No	20% for 5 years beginning year after assessment paid
OR	$300,000	2%	No	3: Health, Life Annuities	No	20% for 5 years beginning year after assessment paid
PA	$300,000	2%	No	3: Health, Life Annuities	Not Addressed	20% for 5 years beginning year after assessment paid
PR	$300,000	2%	No	3: Health, Life Annuities	Not Addressed	
RI	$300,000	3%	Yes	3: Health, Life Annuities	Not Addressed	10% for 5 years beginning year after assessment paid
SC	$300,000	4%	No	3: Health, Life Annuities	Not Addressed	
SD	$300,000	2%	Yes	3: Health, Life Annuities	No	20% for 5 years beginning year after assessment paid, max $2 million/annum
TN	$300,000	2%	Yes	4: Health, Life Allocated Ann, Defined Contrib. Plan Acct.	Yes, if qual. under Sec. 403B	10% for 10 years beg year after; or .1% premiums written
TX	$300,000	1%	Yes	4: Health, Life Annuity, Admin.	Yes, with limitations	20% for 5 years beginning year after assessment paid. Adm expense may reduce tax owed
UT	$300,000	2%	Yes	3: Health, Life Annuities	No, except amts. guar. to indivs. by insrs.	20% for 5 years beginning year after assessment paid
VT	$300,000	2%	No	3: Health, Life	Not Addressed	20% for 5 years beginning year after assessment paid
VA	$300,000	2%	No	3: Health, Life Annuities	No, except amts. guar. to indivs. by insrs.	May offset .05% of gross prem for ins written for account each year
WA	$500,000	2%	Yes	3: Life, Annu., Health, General Account	Yes	20% for 5 years beginning year after assessment paid
WV	$300,000	2%	No	3: Health, Life Annuities	Not Addressed	No
WI	$300,000	2%	Yes, reciprical	5: Life, Annu., Health, P/C, Admin. Acct.*	Not Addressed	20% for 5 years if cannot recoup w/ rate adjustments
WY	$300,000	2%	Yes	3: Life, Annuit Health	No	10% for 10 years beginning year after assessment paid

SOURCES: NOLHGA, NAIC, the guaranty associations of DE, IN, ME, WA, WI

FINANCIAL INSTITUTION INSOLVENCIES
1985 - 1990



Sources: NAIC, FDIC, OTS

Senator BRYAN. Thank you very much, Mr. Mayewski.

We will now hear from Mr. Snyder to tell us about property and casualty.

STATEMENT OF JOHN H. SNYDER, VICE PRESIDENT, PROPERTY AND CASUALTY DIVISION, A.M. BEST CO., OLDWICK, NJ

Mr. SNYDER. Thank you, Mr. Chairman. I might add that my statement does run slightly beyond 5 minutes. And I hope that you will permit me to finish.

Without question, the A.M. Best Co. believes the insurance industry has to be held to the highest standards of financial health since its products and services, its entire economic function, are based on the buyer's good faith that future claims will be honored and serviced.

If the industry's ability to perform this vital economic role becomes impaired, or is perceived to become impaired, the faith required of an insurance buyer to enter into an insurance contract will erode. Similar to a "run on a bank" the undermining of confidence in the industry's financial health could lead to serious financial consequences for both the industry and the public.

In order to take effective steps to maintain a strong insurance industry, it is necessary to fully understand the nature of the insolvencies that have occurred to date, their characteristics and the economic and underwriting environments in which they occurred. A thorough understanding and perspective of past insolvencies will lead to more realistic projections of future insolvency characteristics and trends.

Once this knowledge and understanding is achieved more informed and effective steps can be taken to minimize the industry's insolvencies and contain them within acceptable levels.

My statement will provide a brief overview of our observations and future expectations and conclude with our recommendations to improve the management of the industry's solvency.

Most of my remarks are based on a comprehensive study by the A.M. Best Co. entitled, "A.M. Best, 20-Year Property Casualty Insolvency Study, Facts and Findings," which will be published shortly.

The property-casualty industry is very competitive, with over 3,000 companies competing for a $213 billion market. It experiences a business cycle similar to many other industries. On average the industry follows a 7- to 8-year cycle of 2 to 3 years of improving profitability called "hard markets," followed by 4 to 5 years of declining profitability called "soft markets."

The pattern of insolvencies has followed this business cycle over the past 20 years with the number of annual insolvencies peaking after the conclusion of these soft markets.

At the conclusion of the last two soft markets the property-casualty industry experienced 29 insolvencies in 1975, and 49 insolvencies in 1985.

In 1975 the 29 insolvencies represented approximately 1 percent of the total number of companies in the industry. The 1985 peak of 49 insolvencies represented 1.4 percent of the total companies.

In terms of the premium volume that these insolvencies represented as a percentage of the entire industry, these insolvencies have never represented more than 0.5 percent of the total industry's premium volume, with the exception of 1985 when it approximated 1.3 percent.

The soft market that began in 1978 and concluded in 1985 was the longest and most severe underwriting decline the industry has experienced to date. Factors that fueled the demise of so many companies included volatile and very high interest rates, cash-flow underwriting, new capacity and severe industry competition, and the liberalization of tort laws and policy contract interpretation.

Without question, the industry has experienced changing and rising trends in the number and magnitude of insolvencies. For example, the 1970's were characterized by small- and medium-sized insolvencies of predominantly personal lines companies; that is, companies underwriting private passenger automobile and homeowners' insurance coverage.

However, the 1980's were characterized by small- and medium-sized insolvencies of predominantly commercial lines companies. In 1985 a number of larger sized insolvencies occurred, triggering an unusual level of guaranty fund assessments.

Since 1985, the number of insolvencies has remained historically high. However, the number of insolvencies remain lower than the 1985 peak and represent less than 0.5 percent of the industry's premium volume which has been a level observed over the last 20 years.

In terms of insolvencies by State, the top six States have accounted for 50 percent or 182 of all the insolvencies that have occurred over the past 20 years. These six States also represent some of the largest States in terms of the number of domiciled companies and, therefore, it is expected that these States would account for the bulk of the insolvencies.

Over the past 20 years these six States have represented 34 percent of all the property-casualty companies and 50 percent of the insolvencies. This relationship does suggest a disproportionately high share of insolvencies occurring within these six States.

Our analysis of over 360 insolvencies has produced a profile of a company which has experienced a high probability of failure. The profile that has emerged is that of a young, small- to medium-sized stock company underwriting predominantly commercial lines coverages and experiencing unusual growth characteristics.

To support this high-risk profile, our study has found that stock companies fail at a rate that is four times greater than mutual companies.

Companies experiencing growth in premium that is outside the industry norms of between 5 and 25 percent accounted for 80 percent of the insolvencies. Young companies represented a large percentage of the insolvencies, with companies operating 10 years or less accounting for 41 percent of all insolvencies and companies operating 15 years or less accounting for 52 percent of all insolvencies.

Finally, commercial lines companies have experienced significantly greater failure frequencies than personal line companies in the last 10 years.

I would now like to outline our expectations of future insolvency trends.

Adequate growth of the industry's premium volume is essential to minimize industry insolvencies. Adequate growth is necessary to offset rising claims cost inflation and the increasing amount of litigation involved in settling claims. The industry's insolvencies have climbed dramatically following long soft markets of little premium volume growth.

The A.M. Best Co. estimates that the current soft market, which the industry entered in 1987, will bottom in 1991 to 1992. The length of the current soft market will be shorter and less severe than the 1978 to 1985 soft cycle due to the lower interest rate environment and declining competitive pressures within the industry.

We anticipate that insolvencies will peak during 1990 to 1991 at approximately 1 percent of the industry's companies and will represent approximately 0.6 percent of the industry's premium volume.

Both the number and magnitude of these insolvency expectations are significantly lower than the levels experienced in 1985 when the industry's insolvencies approached 1.4 percent of the total number of companies and represented 1.3 percent of the industry's total premium volume.

Our findings and expectations do not support the belief that the insurance industry is on the verge of a collapse or a financial demise similar to that experienced by the savings and loan industry.

I would now like to suggest some recommendations to improve solvency management of the industry.

The ability of the A.M. Best Co. to measure and monitor policyholder security through the assignment and monitoring of Best's ratings has been very effective. Over the past 20 years our study has identified 364 insolvent companies, of which 50 percent were followed by A.M. Best.

Our rating process identified virtually all companies approaching insolvency by significantly downgrading or removing their Best rating. Since 1969 only 12 percent of the insolvent companies held an A rating 3 years prior to their insolvency. By the year of the insolvency, only 1.6 percent of the insolvent companies held an A rating.

As these companies approached their insolvency, virtually all of these A-rated companies were identified as companies experiencing difficulty and their ratings were rapidly lowered or removed.

As a measure of A.M. Best's overall effectiveness, only 0.3 percent of our A-rated companies have gone insolvent over the past 20 years, which averages to one A-rated company becoming insolvent in 1 out of every 3 years.

The A.M. Best Co. currently follows more than 2,400 property-casualty companies. These companies together represent over 99 percent of the industry's premium volume.

The key to our rating effectiveness is our understanding and knowledge of the entire industry, including both its financial and management aspects. Our monitoring process of the industry focuses on both the quantitative and qualitative aspects of insurance companies and involves a detailed understanding of each individual company's financial condition, product lines, operations, marketing, reinsurance, underwriting, investment philosophies, and most importantly, management's capabilities and objectives.

Our rating system, in addition to our close relationship with the industry, has played a major role in the prevention of insolvencies.

We believe insolvency detection is a by- product of a good system of insolvency prevention.

No system of solvency management can rely on financial monitoring alone. A qualitative review of an insurance company and its management is essential and that is why the A.M. Best Co. meets annually with the majority of the companies we follow.

We recommend that a more effective regulatory system to manage insurance company solvency incorporate the five following features.

We will provide a more comprehensive list of recommendations in our formal insolvency study.

Recommendation No. 1: State regulators incorporate in their oversight a formal review of the companies that the A.M. Best Co. identifies as potential high-risk candidates. Our annual review, combined with our 6- and 9-month monitoring, identifies hundreds of companies that potentially warrant closer regulatory attention.

Our ability to identify companies that are potentially facing financial difficulties has been proven to be very successful and our analysis should supplement the regulator's role. Companies that are not reported on by A.M. Best Co. also warrant closer regulatory attention since they have also accounted for a large number of the insolvencies.

No. 2: more frequent financial examination of companies that exhibit high-risk operating characteristics as outlined in our insolvency study.

No. 3: more frequent financial examination of new or unseasoned companies.

No. 4: more standardized risk-adjusted capitalization requirements to reflect the different degrees of risks associated with different types of insurance coverage.

No. 5: stiffer fines and penalties to deter misleading or fraudulent financial reporting.

That concludes my statement.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Snyder follows:]

PREPARED STATEMENT OF MR. SNYDER

OPENING REMARKS

Without question, the A.M. Best Co. believes the insurance industry has to be held to the highest standards of financial health since its products and services, its entire economic function, are based on the buyer's good faith that future claims will be honored and serviced. If the industry's ability to perform this vital economic role becomes impaired, or is perceived to be impaired, the faith required of an insurance buyer to enter into an insurance contract will erode. Similar to a "run on a bank," the undermining of confidence in the industry's financial health could lead to serious financial consequences for both the industry and the public.

In order to take effective steps to maintain a strong insurance industry, it is necessary to fully understand the nature of the insolvencies that have occurred to date, their characteristics and the economic and underwriting environments in which they occurred. A thorough understanding and perspective of historical insolvencies will lead to more realistic projections of future insolvencies' characteristics and trends. Once this knowledge and understanding is achieved, more informed and effective steps can be taken to minimize the industry's insolvencies and contain them within acceptable levels. My statement will provide a brief overview of the scope and magnitude of the insolvencies that have occurred to date, including our observations and future expectations, and conclude with our recommendations to improve the management of the industry's solvency. Most of my remarks are based on a comprehensive study by the A.M. Best Co. entitled “A.M. Best's 20 Year Property-Casualty Insolvency Study—Facts & Findings,” which will be published shortly.

NATURE OF INSOLVENCIES OVER THE PAST 20 YEARS

The property-casualty industry is very competitive with over 3,000 companies competing for a $213 billion market and it experiences a business cycle similar to many other industries. On average, the industry follows a 7–8 year cycle of 2–3 years of improving profitability, called “hard markets,”, followed by 4.5 years of declining profitability, called “soft markets.” The pattern of insolvencies has followed this business cycle over the past 20 years, with the number of annual insolvencies peaking alter the conclusion of these sort markets. At the conclusion of the last 2 sort markets, the property-casualty industry experienced 29 insolvencies in 1975 followed by 49 insolvencies in 1985. In 1975, the 29 insolvencies represented approximately 1 percent of the total number of companies and the 1985 peak of 49 insolvencies represented 1.4 percent of the total companies. In terms of the premium volume that these insolvencies represented as a percentage of the entire industry, these insolvencies have never represented more than 0.5 percent of the total industry's premium volume with the exception of 1985 when it approximated 1.3 percent. The sort market that began in 1978 and concluded in 1985 was the longest and most severe underwriting decline the industry has experienced to date. Factors that fueled the demise of so many companies included volatile interest rates, cash-flow underwriting, new capacity and severe industry competition, and the liberalization of tort laws and policy contract interpretation. Without question, the industry has experienced changing and rising trends in the number and magnitude of insolvencies. For example, the 1970's were characterized by small- and medium-sized insolvencies of predominantly personal lines companies (i.e., companies underwriting private passenger automobile and homeowners' insurance coverages). However, the 1980's were characterized by small- and medium-sized insolvencies of predominantly commercial lines companies. In 1985, a number of larger sized insolvencies occurred, triggering an unusual level of guaranty fund assessments. Since 1985, the number of insolvencies has remained historically high, however, the number of insolvencies are lower than the 1985 peak and represent less than 0.5 percent of the industry's premium volume which has been a level observed over the last 20 years.

In terms of insolvencies by State, the top six States have accounted for 50 percent, or 182, of all the insolvencies that have occurred over the past 20 years. These six States also represent some of the largest States in terms of the number of domiciled companies and, therefore, it is expected that these States would account for the bulk of the insolvencies. Over the past 20 years, these top six States have represented 34 percent of all the property-casualty companies and 50 percent of all the insolvencies. This relationship does suggest a disproportionately high share of insolvencies occurring within these six States.

Our analysis of over 350 insolvencies has produced a profile of a company which has experienced a high probability of failure. The profile that has emerged is that of a young, small to medium-sized stock company underwriting predominantly commercial lines coverages and experiencing unusual growth characteristics. To support this high-risk profile, our study has found that stock companies fail at a rate that is 4 times greater than mutual companies. Companies experiencing growth in premium that is outside the industry norms of between 5 to 25 percent accounted for 80 percent of all the insolvencies. Young companies accounted for a large percentage of the insolvencies, with companies operating 10 years or less accounting for 41 percent of all insolvencies, and companies operating 15 years or less accounting for 52 percent of all insolvencies. Finally, commercial lines companies have experienced significantly greater failure frequencies than personal lines companies in the last 10 years.

A.M. BEST'S EXPECTATIONS OF FUTURE INSOLVENCY TRENDS

Adequate growth of the industry's premium volume is essential to minimizing industry insolvencies. Adequate growth Is necessary to offset rising claim cost inflation and the increasing amount of litigation involved in defending and settling claims. The industry's insolvencies have climbed dramatically following long sort markets of little premium volume growth. The A.M. Best Co. estimates that the current sort underwriting market which the industry entered in 1987 will bottom in 1991–92. The length of the current sort market will bc shorter and less severe than the 1978–85 sort cycle due to the lower interest rate environment and declining competitive pressures within the industry. We anticipate that the industry's insolvencies will peak during 1990–91 at approximately 1 percent of the industry's companies and will represent approximately 0.6 percent of the industry's premium volume. Both the number and magnitude of these insolvency expectations are significantly lower than the levels experienced in 1985 when the industry's insolvencies approached 1.4 percent of the total number of companies and represented 1.3 percent of the industry's total premium volume. Our findings and expectations do not support the belief that the insurance industry is on the verge of a collapse similar to that of the savings & loan industry.

RECOMMENDATIONS TO IMPROVE SOLVENCY MANAGEMENT OF THE INDUSTRY

The ability of the A.M. Best Co. to measure end monitor policyholders' security through the assignment and monitoring of Best's ratings has been very effective. Over the past 20 years, our study has identified 364 insolvent companies of which 50 percent were followed by A.M. Best. Our rating process identified virtually all companies approaching insolvency by significantly downgrading or eliminating their Best's rating. Since 1969, only 12 percent of the insolvent companies held an "A" rating 3 years prior to their insolvency. By the year of insolvency, only 1.6 percent of the insolvent companies held an "A" rating. During the first and second years prior to their insolvency, virtually all of these "A" rated companies were identified as companies experiencing difficulty and their ratings were rapidly lowered or removed. As a measurement of A.M. Best's overall effectiveness, only 0.3 percent of our "A" rated companies have gone insolvent over the past 20 years, which averages to one "A" rated company becoming insolvent in one out of every 3 years. The A.M. Best Co. currently follows more than 2,400 property-casualty companies. These companies together represent over 99 percent of the industry's premium volume.

The key to our rating effectiveness is our understanding and knowledge of the entire industry, including both its financial and management aspects. Our monitoring process of the industry focuses on both the quantitative and qualitative aspects of insurance companies and involves a detailed understanding of each individual company's financial condition, product lines, operations, marketing, reinsurance, underwriting and investment philosophies, and most importantly, management's capability and objectives. Our rating system, in addition to our close relationship with the industry, has played a major role in the prevention of insolvencies. We believe insolvency detection is a by-product of a good system of insolvency prevention. No system of solvency management can rely on financial monitoring alone. A qualitative review of an insurance company and its management is essential and that is why the A.M. Best Co. meets annually with the majority of the companies we follow.

We recommend that a more effective regulatory system to manage insurance company solvency incorporate the five following features. (We will develop a more comprehensive list of recommendations in our formal solvency study to be published shortly.)

1. State regulators should include a formal review of the companies that A.M. Best identifies as potential "high risk" candidates. Our annual review, combined with our 6- and 9-month monitoring, identifies hundreds of companies that potentially warrant closer regulatory attention. Our ability to identify companies that are potentially facing financial difficulty has been proven to be very successful and our analysis should supplement the regulator's role. Companies that are not reported on by A.M. Best also warrant closer regulatory attention since they have accounted for a large number of insolvencies.
2. More frequent financial examination of companies that exhibit high-risk operating characteristics as outlined in our insolvency study.
3. More frequent financial examination of newer, or unseasoned, companies.
4. More standardized risk-adjusted capitalization requirements to reflect the different level of risks associated with different types of insurance coverage.
5. Stiffer fines and penalties to deter misleading or fraudulent financial reporting.

Senator BRYAN. Thank you very much, Mr. Snyder.

Mr. Taub, we will now hear from you.

STATEMENT OF ROY TAUB, EXECUTIVE MANAGING DIRECTOR OF INSURANCE RATING SERVICES, STANDARD AND POOR'S CORP., NEW YORK, NY

Mr. TAUB. Thank you and good morning.

This hearing underscores the public's heightened concern about the financial stability of the insurance industry. Certainly the severe problems of the thrift industry and growing questions about the banking system have contributed as well to a concern about the health of the Nation's insurance companies.

I would like to begin with two basic points. S&P does not believe that the insurance industry is heading for a savings-and-loan-type crisis or that the difficulties of the magnitude that the banking industry is now facing are inevitable for insurance.

On the other hand we do not believe that a crisis or fear of an impending crisis should be necessary in order for the financial health of insurance companies to receive increased attention.

The insurance industry is under greater financial stress today than in years past. As you have already heard insurance company insolvencies have been growing, although they still represent a very small percentage of the thousands of U.S. insurers. And with very few exceptions, it has been smaller insurers, those with less than about $100 to $200 million in assets that have become insolvent.

When we move up the size scale, S&P does not believe the risk of having an appreciable number of insolvencies over the next several years is significant. We do believe, however, that the credit quality or financial strength of many of the midsize or larger insurers has weakened over the past few years.

In 1988, for example, 53 U.S. insurers carried S&P's highest claims paying ability rating, AAA. Today less than 40 of those same 53 retain the AAA. While most of the hundreds of insurers that we rate still have ratings in our four highest categories, indicative of fundamentally sound financial quality, a growing portion of our ratings are AA category, A category, and even BBB category. That means we feel they are still secure, but somewhat more vulnerable than before.

The leading cause of the lower ratings for life insrers has been asset quality, with losses on junk bond investments, mortgage and real estate the leading culprits. For property-casualty insurers, the problems have been less spectacular, but perhaps more fundamental.

The high level of tort awards, escalating health care costs, major environmental liabilities and so on, have contributed to greater unpredictability as well as greater severity of the claims these insurers must pay. At the same time, pricing has been pressured both by consumer and political action and by cyclical competitive factors.

However, all the problems must be kept in perspective and comparisons with the savings and loans and banking industries should be made with considerable caution. For example, junk bond investments were a contributor to many savings and loan collapses. Standard & Poor's thinks that junk bond defaults could hit 10 percent or more for the next year or two, but junk bonds represent a major concentration of assets for only about 20 insurers, and many of those offset their junk bond risk with a conservative capital position, typically far more conservative than what most thrifts have.

Mortgage and real estate losses are another common but not equivalent problem. We do expect insurers to have continued losses for mortgage and real estate assets. Our surveys indicate that slightly more than 15 percent of the mortgage loans held by life insurance companies can be classified as some form of problem loan.

In turn, of those problem loans, S&P believes that some 15 percent of them may turn into losses over the next 3 years.

Certainly this is not a pleasant prospect, but again, we do not believe that it carries solvency-threatening concerns for most insurers.

Finally, we need to remember that insurance liabilities are significantly different than savings and loans and banks. Though unpredictability of some insurance liabilities require most insurers to be strongly capitalized, and most in fact are compared to banks and S&L's, insurance liabilities still tend to be relatively predictable and perhaps even more importantly they typically develop over a relatively lengthy period of time.

For that reason, with few exceptions, the liquidity crunch that banks and thrifts may face in difficult times is not typical for insurers, and that mitigates the potential damage from asset quality problems.

Standard & Poor's is not sanguine about the possibility that the financial problems that we have described may continue or even worsen, but we do believe that many of the problems can be addressed by appropriate management action to deal with such fundamental issues as pricing, investment practices, and expense control.

Beefed-up regulatory scrutiny that many have called for can certainly play a valuable role in keeping insurance managements from creating financial risk to their policyholders, and certainly mismanagement and fraud have been contributors to many insolvencies that have occurred. But S&P believes that managements must also have a significant business incentive to operate in a financially prudent manner.

In that regard, guaranty funds, which have also gotten greater attention recently, can be a double-edged sword. On one hand, it is natural for Government to want to provide a safety net for consumers depending on insurance for vital needs.

On the other hand, as we saw with the thrifts and to some extent with banks, consumers who see little need to worry about the safety of their principal or their expected insurance payment because the Government is there if needed have little reason to factor an institution's financial strength into their deposit or insurance purchase decision. This, in turn, makes it more difficult for the market to exert the discipline that would require companies to remain financially secure in order to be effective competitors.

We believe that the market and consumers benefit most when as much information about insurance companies as possible is available, including information about individual insurers' financial well-being. Independent, objective credit ratings from organizations such as Standard & Poor's have helped for decades to enable this country's bond markets to operate in an efficient manner. Ratings have helped investors make decisions with good information about the risk, as well as the return side of the investment equation. We believe that ratings can and do play a similar role in the insurance marketplace, and we of course hope that role will continue to grow.

Based on the increasing number of phone calls we get, insurance buyers in growing numbers want to know whether that high rate they are offered on an investment-type insurance product or the lowest price they may be offered for some form of coverage is coming at the risk of dealing with a financially vulnerable insurer. They believe that a rating on their prospective insurer is valuable information in helping them make their decision, so market forces are indeed beginning to work.

Mr. Chairman, we welcome the committee's concern and interest in the subject of insurance company solvency. It is an issue we grapple with daily, and we stand ready to assist with information and analysis in any way we can.

Thank you very much.

[The prepared statement of Mr. Taub follows:]

PREPARED STATEMENT OF ROY TAUB

Thank you, Mr. Chairman. I am Roy Taub, executive managing director of the Insurance Rating Services unit of Standard & Poor's Ratings Group. This hearing—which joins other inquiries by Federal and State government, consumer groups and others—underscores the public's heightened concern about the financial stability of the insurance industry. In particular, the severe problems of the thrift industry and growing questions about the banking system, have naturally led to a general concern about the health of the nation's financial intermediaries, including insurance companies.

I'd like to make two basic points at the outset. On the one hand, S&P does not believe that the insurance industry is headed for a savings & loan-type crisis, or that it will inevitably face difficulties of the magnitude that the banking industry is now facing.

On the other hand, we do not believe that a crisis—or fear of an impending crisis—should be necessary in order for the financial health of insurance companies to receive increased attention. In fact, to the extent that responsible authorities, and perhaps even more importantly, the insurance marketplace itself, routinely pay greater attention to the financial well-being of insurers, we believe the likelihood that the insurance industry will face a real solvency crisis at any point in the future will be significantly reduced. This hearing contributes significantly to that process.

INSURANCE INDUSTRY TODAY

What is S&P's view of the insurance industry today? As I've said, Mr. Chairman, we don't see a new savings & loan-type calamity on the horizon. But the insurance industry is under far greater financial stress than in years, or for that matter, decades past. Insurance company insolvencies have been growing, although on an annual basis, they still represent a very small percentage of the thousands of U.S. insurers. And with very few exceptions, it has been smaller insurers—those with less than about $100–$200 million in assets—that have become insolvent. Thus, the percentage of insurance assets, surplus and premiums that have been affected by insolvency is even smaller than the percentage of companies that have become insolvent.

While many smaller insurers are financially sound, we believe that the increased rate of insolvency among smaller insurers may well continue over at least the next few years. The smaller capital or surplus base that defines these insurers, and the lack of business diversity that their smaller size often dictates make them more vulnerable in a number of ways. To cite a few, they may be less able to withstand or adjust to strong competition in their primary or sole line of business or geographic market. An attempt to rapidly grow a line of business is risky for any insurer, but may more likely be fatal for a smaller insurer. A small surplus base may be less able to withstand shocks from unanticipated claims of significant size, from uncollectible reinsurance, or from asset quality problems.

To reiterate, the majority of smaller insurers should remain sound. But the larger incidence of serious problems that we've seen in recent years among smaller insurers seems likely to continue.

When we move up the size scale—to mid-sized insurers with more than $200 million in assets, and even more so, to large insurers with $1 billion or more in assets, S&P does not believe that the risk of having an appreciable number of insolvencies over the next several years is significant. We do believe, however, that the credit quality or financial strength of many of these insurers has weakened over the past few years. Generally, that quality is still good, but it's not as good as it used to be.

The reasons for the weakening trend are numerous, and they differ from insurer to insurer. A detailed analysis of the reasons requires looking at the various industry sectors separately. We'd be pleased to provide additional details of our work in these areas if the committee wishes.

There are some key points to be made. In the life insurance sector, asset quality has been the primary source of concern and problems. Junk bonds and mortgage and real estate loans have been the major problem assets, accounting for about five percent and about a quarter of industry assets respectively.

Property/casualty insurers have not faced asset quality problems—their assets are most typically concentrated in high quality bonds. But the property/casualty sector is faced with weakening fundamentals. A variety of factors, including the rising level of tort awards, escalating health care costs, major environmental liabilities, and so on, have contributed to greater unpredictability as well as greater severity of the claims these insurers must pay.

At the same time, pricing for personal lines insurance, particularly auto insurance, has been dampened by consumer and political pressure, and commercial lines pricing is adversely affected by prolonged cyclical competitive pressure.

No one wants to pay more for insurance, but the simple fact in commercial lines, as in personal, is that losses and operating expenses continue to escalate, and unless these cost increases are matched with price adjustments, continued deterioration in financial results is a certainty.

Nevertheless, It is important to understand the difference in the nature of the liabilities held by insurance companies vs. those held by banks and savings & loans.

Even though some insurance company liabilities have become more unpredictable, they still tend to be relatively predictable, and get paid out over a long period of time. In contrast, banks and S&L's may face a liquidity crunch if depositors perceive that the health of the institution is in jeopardy and remove their deposits abruptly. The insurance industry is not totally immune to liquidity problems, but it is inherently harder for policyholders to take their money out of an insurance company than a bank or S&L, and therefore, insurance companies are better positioned to ride out an asset quality storm.

HOW BAD IS IT?

To put some perspective on the decline in credit quality we have seen among insurers, let me review some trends. S&P maintains ratings of the claims-paying ability of hundreds of U.S. insurance companies, most of them large and mid-sized companies which voluntarily submit to our ratings scrutiny.

Three years ago, 53 insurance companies qualified for our top, or AAA, rating. This year, less than 40 of those same companies remain rated AAA. There is no question that this represents a deterioration in financial strength, but this in no way indicates a wholesale risk of impending insolvencies. Let me look briefly at some areas which have received significant attention.

One of the highest profile factors in the S&L crisis was the role people believed was played by junk bond investments in causing S&L collapses. Many people are concerned about junk bond investments in the insurance industry.

The reality is that the number of insurance companies where below-investment grade bonds represent a significant concentration of assets is very small—on the order of around 20 companies. And as I've noted, junk bonds represent only about five percent of the assets held by the life insurance industry, and are not an issue at all for the property/casualty insurance industry.

Another area of anxiety has been the nature and quality of real estate and mortgage loans in which insurance companies have invested. In fact, on average, the quality of these investments by insurance companies has been better than similar investments by banks and S&L's. This stems largely from the fact that S&L's have provided construction financing in the real estate sector, while insurance companies have mainly provided permanent financing after construction is completed.

We do expect continued losses from mortgage and real estate assets. Our surveys indicate that slightly more than 15 percent of the mortgage loans held by life insurance companies are classified as some form of problem loan. In turn, of those problem loans, we think that some 15 percent may turn into losses over the next 3 years. This is not a pleasant prospect, but again, we don't believe that it carries solvency-threatening concerns for most insurers.I89THE WAY OUT OF DIFFICULTY

The problems of the insurance industry are far from being insoluble. There are specific actions that could aid the industry in its recovery.

First and foremost, insurance company managements have contributed to these problems, because they made the decisions to seek high-yielding investments—which led them to place money in assets that were inherently riskier. Managements have also been responsible for the pricing decisions—made in response to competitive pressures from other companies—that have led to the writing of poorly profitable or even unprofitable policies.

In general, managements can manage their way out of many of these problems by examining and modifying their investment and pricing policies. In fact, many managements have already begun executing a turnaround along these lines. In addition, it probably makes sense for regulators to broaden their scrutiny of the industry to guard against instances of mismanagement.

There has been some debate over whether to establish an insurance guaranty fund on the Federal level. S&P views this question as a two-edged sword. On the one hand, it may make sense for the government to provide a safety net for the consumer who buys an insurance policy, only to discover that there is no money there to pay his or her claims.

On the other hand, however, as we've seen in the S&L debacle, insurance or guaranty funds tend to make consumers oblivious to the financial risk profile of their financial intermediaries. If I know that the government is going to protect me from losing my insurance premium through a guaranty fund, I am likely to be less interested in the financial health of my insurance company.

The consequence of this, of course, is that a guaranty fund structure makes it more difficult for the market to exert the discipline that would require companies to clean their financial houses in order to be effective competitors. There is a danger of complacency when the market does not offer an incentive for consumers to consider solvency issues.

So, although no one would debate the importance of insurance guaranty funds as basic to consumer protection, regulators, legislators, and indeed, the industry itself, have all wisely focused on prevention rather than salvage as the most effective, least costly way of protecting consumers.

A major emphasis, therefore, should be on devising more rigorous methods to monitor and identify insurers that are strong and those that are weak.

We do think the market and consumers benefit most when the market has a greater well of information about insurance companies that can be useful to those making the insurance purchase decisions. We think independent, objective ratings of the creditworthiness and claims-paying ability of insurance companies go a long way toward providing this kind of information.

In fact, S&P plans to broaden its insurance ratings programs in the near future to include a new series of Qualified Solvency Ratings on more than 2,500 smaller insurance companies, many of which have not previously been evaluated by any ratings agency.

Mr. Chairman, we welcome the committee's concern and interest in the subject of insurance industry solvency—an issue we grapple with every day—and we stand ready to assist with our analytical expertise.

Thank you very much.

Senator BRYAN. Thank you very much, Mr. Taub. Mr. Kramer?

STATEMENT OF ORIN KRAMER, PRESIDENT, KRAMER ASSOCIATES, INFORMATION INSTITUTE

Mr. KRAMER. Thank you, Mr. Chairman. My name is Orin Kramer. I am the president of Kramer Associates, a New York-based public policy and economic consulting firm, and I will limit my remarks to 5 minutes. I would ask the Chair that my written testimony be entered into the record.

Senator BRYAN. It will be made a part of the record, Mr. Kramer.

Mr. KRAMER. Last year, I undertook a comparative assessment of risk levels among property and casualty insurers, life insurers, and commercial banks. The study was commissioned by the Insurance Information Institute but the analysis and conclusions are my own. I would like to offer just a few generalizations that arose out of that study.

No. 1, for each sector—property-casualty insurance, life insurance, commercial banks—there is some set of events, however unlikely, that could precipitate a solvency crisis. Risk levels are by far the highest in banking. On the other hand, the ability, whether one likes it or not, of the regulatory system to defer if not avoid a crisis is also the highest in banking.

I should say that the reason I understood this comparative analysis is because in political terms the question tends to be raised in the context of, how do insurers compare to banks and thrifts, and so that is why it was designed to try and answer that.

The second general point is that there are common elements among all the sectors. Insolvencies and risk levels have risen for each sector. Profitability on a long-term basis has declined for each sector. Each sector has suffered from excess capacity and excessive competition over the 1980's. Each sector has lost a lot of what used to be its most attractive customer groups. There are also, as a number of observers have noted, substantial similarities in the behaviors of the managements of failed insurers, banks, and thrifts.

However, I would argue that the inference that many people have drawn from those conclusions—namely that risk levels are comparable across the sectors—that that conclusion is entirely unwarranted. There are sharp differences in both the nature of the threat and the degree of threat facing the different sectors.

The third point is that it is important to distinguish between the tales of villains and thieves which are widely perceived to be the source of most financial institution failure, and the structural factors that would produce a solvency crisis if such an event were to occur.

For property-casualty carriers, the major, real structural threats are:

One, the risk of a major midday earthquake in a major city in the absence of some sort of Federal backup facility, which does not exist today.

Two, the risk that the courts would impose upon the property-casualty industry some significant share of the cost of cleaning up the environment.

Three, the inherent difficulties in establishing reserves for policies where claims are not going to be paid for many years until after the policy is written.

Four, pressure on operating margins if the trend that we have seen in recent years toward this depression of rates below adequate levels in some jurisdictions, if that trend were to continue.

For lots of companies I would say that the primary thread is No. 1, credit policy risk. You would have a problem if you are looking at a long-term, severe devaluation of commercial real estate values. There is, as the committee is well aware, some junk bond exposure, but in general that is a lesser problem.

Second, for some companies, mismatches between assets and liabilities then end up creating interest rate risk. Just for comparative purposes for commercial banks, the biggest threat is continued deterioration in commercial real estate values, and to a lesser degree the exposure they have in what are called HLT loans, loans to highly leveraged borrowers. LBC loans are much less of a problem for banks today. No. 2 for banks, rise in capital costs imposed by the marketplace. And No. 3, liquidity pressures as investors respond to rising risk levels. For many weak banks, there has already been what amounts to a slow quiet run by institutions.

Bottom line is that over the next several years, while it is possible to hypothesize conditions that might produce the insolvency of a major insurance company, such an event is pretty unlikely. The risk of a major life company insolvency is somewhat greater than on the PC side, but there is no evidence today that the insurance industry faces a systemic solvency threat. And there is no reasonable probability that the circumstances that conceivably could produce such an outcome will in fact exist.

If I can interject a final, general note about regulatory policy, I would suggest that the most severe structural problem facing every sector of the financial services industry is excess capacity—too many players with inadequate skills chasing too few good business opportunities. Optimally, excess capacity would exit through voluntary consolidations, whether it is in banking or in insurance. And I think that generally that will be the case. But regulatory policy ought to recognize that the health of the financial system requires cleansing that system of excess capacity, and failures are part of the short-term price that has to paid for a system that is going to be healthier over the long term.

Regulatory forebearance, the failure of regulators to act promptly when faced with a weak and deteriorating institution, increases the ultimate cost of failure and weakens healthier competitors. The objective ought to be minimizing the size and cost of failures and preserving the stability of the financial system, not the avoidance of failure, per se. As we have seen in the thrift instance, keeping weak players in the game—and it is equally true in banking or in insurance—ultimately produces greater long-term instability in the system.

Thank you, Mr. Chairman.

Senator BRYAN. Thank you very much, Mr. Kramer, and to each of you for your insights. Let me try to distill this into something that may be a more operable framework for us to deal with here in the Congress. Let me ask the two representatives from A.M. Best—you have summarized, I believe it was Mr. Snyder's testimony, the five recommendations that you think ought to be taken. Do you believe that those recommendations can be implemented with the present regulatory structure or does it require any Federal action on your part? Mr. Snyder, maybe you are the author of the summary, although Mr. Mayewski, I think, is probably bound to some extent—he incorporated by reference some of your comments. Let me hear your response.

Mr. SNYDER. Mr. Chairman, without question, these are five very general recommendations and preliminary in nature. The final list of recommendations will be included within the study once it is released. But these are certainly five recommendations that could be very easily implemented and utilized with varying degrees among the 50 States.

I think the standardization issue across the 50 States and the NAIC's certification efforts to bring up the overall level of standards, which, although I am not familiar with the details of the certification process, have some aspects of some of these recommendations. It is a question of more effectively spending and utilizing regulatory dollars and manpower in addressing solvency issues.

Unfortunately the regulators have their hands full with issues other than just solvency issues. There is market conduct, filings, you name it, they have their plate full with a variety of responsibilities. Solvency is one of them.

Senator BRYAN. Mr. Snyder, I am not sure we are hitting really the question. I am assuming for purposes of my question that these five recommendations are accepted as being necessary to prospectively address any problems within the industry. And my question, really more specifically is are you satisfied from your point of view whether these can be effectively done at the State level? Will they be done on the State level, or do you think—and I just ask this by way of a question, not a judgmental question, they require some type of Federal legislation to insure that they are adopted?

Mr. SNYDER. Yes, Mr. Chairman, it could be effectively implemented at the State level.

Senator BRYAN. At the State level.

Let me ask you, Mr. Taub, and ask Mr. Kramer to join in if you have a comment. One of the questions that comes to a lot of us as we look at this broad perspective of financial services generally, is what kind of linkages, if any—and I underscore if any exist—is there a linkage between the failure of the savings and loans—the problems which the banking system faces—and any concerns that we ought to have about the insurance system. And I am not asking that so much in terms of are there parallel causes that may lie at the base of some of these problems. But assuming that the savings and loan situation continues to deteriorate, assuming further that the banking system continues to be under severe pressure, what impact, if any, does that have on the insurance industry?

Mr. TAUB. It is pretty tough to generalize on that point, I think. Certainly the banks in particular, and the thrifts as well, play, as you well know a major role in the U.S. economy.

Senator BRYAN. No question.

Mr. TAUB. I think that the weakness in the thrifts has already been absorbed to some extent, but certainly the impacts of that are not completely over. The impacts from the banking problems are still developing. So, first of all, to the extent that they tend to create changes and additional problems in the U.S. economy and financial system at large, that certainly is going to affect the insurance industry to some extent.

But I do not think that that necessarily implies that they are going to somehow drag the insurance industry down with them. I think that many of the business fundamentals that the insurance industry must deal with are very much separate. Again, the nature of the liabilities is very much separate. How funds enter the industry is very much different. So, I think that, again, other than an impact on the general economy, I do not think it is inevitable that problems of thrifts and banks will drag the insurance industry down as well.

Senator BRYAN. Mr. Kramer, your observation, sir.

Mr. KRAMER. For property-casualty companies, virtually not at all because the property-casualty risk factors such as they are do not include commercial real estate. Commercial real estate represents about 3 percent of total property-casualty assets. And that is where you would get the hook in from banks, and to a lesser degree, thrifts.

On the life side, the fastest growing category of bank lending over the 1980's was commercial real estate. That window is obviously closed. To the extent that there is a significant absence of bank funding, and to the degree that that contributes to a significant reduction in commercial real estate values, then life companies that have a lot of commercial real estate will see at least the market values of those properties decline.

Most life companies do not have a lot of liquidity pressure. In other words, the do not have to sell those properties when the values decline. But if you are still looking at the books and you are saying, what is this asset worth, to the extent that the banks cannot extend credit in commercial real estate, there is pressure. Other than that, I do not think there is anything that is significant.

Senator BRYAN. Let me ask you, Mr. Kramer, and then you, Mr. Taub, your analysis of the situation in the insurance industry today, does that suggest to you that generally a prudent person who is a Member of the Congress—should we be sufficiently concerned that we initiate any Federal action, any Federal response to prevent any further significant problems in the industry, or are you satisfied with the present regulatory framework, which is essentially—as we have heard this morning, as we all know—a State-by-State basis?

Mr. KRAMER. I have wrestled with that question a great deal, Senator.

Senator BRYAN. And I want to be sure that you do not think that I am prejudging what the solution is. But your expertise is certainly something that I think is an important part of the record.

Mr. KRAMER. And I have difficulty with the question. On the one hand, optimally we would see greater uniformity, consistency, quality among the States. The NAIC is moving in that direction. I frankly think that there are certain limitations inherent in a State-based regulatory system that despite the best efforts of the NAIC, you cannot fully overcome.

On the other hand, and this ends up becoming a more extended discussion, but I personally would have real concerns that the kinds of Federal approaches that would likely be taken would be approaches which would end up exacerbating the problem rather than fixing it.

Senator BRYAN. There is some historical evidence to support that.

Mr. KRAMER. No, but I mean without being demagogic and going into the banking and thrifts and et cetera, I think that there are a number of political forces that would tend to push the system toward solutions that substantively do not end up making the problem better. So, I cannot give you a clear-cut answer. I sort of end up getting stuck on it.

Senator BRYAN. Well it sounds like you are probably more comfortable to keep the regulatory system pretty much as it is.

Mr. KRAMER. Imperfect as it is. Not because in principal one could not have a better Federal approach. But because at least to my own mind, the probability is that you would not in fact develop a better approach. And part of the reason actually is the banking and thrift experience which, I think, ends up creating certain lessons which, in this instance, might end up creating difficulties.

Senator BRYAN. Mr. Taub, how about your own?

Mr. TAUB. I think that on one hand, strengthening of the regulatory system to be more certain that instances of gross mismanagement and fraud can be handled promptly and addressed correctly, that certainly is necessary. Whether that again requires Federal involvement or not, I think it does not necessarily have to.

I think reporting of information by the companies, the consistency of it that someone mentioned earlier, and better interim reporting is desirable. I think getting information on a more consistent and more useful basis is a very important thing. And again, I think that could be done with better State regulation, not necessarily requiring Federal regulation.

I would also say, though, that to me the emphasis on regulation as the answer, I think in itself may be part of the problem. I think unlike the capital markets where the marketplace very clearly considers a risk return type analysis, that has not typically been the case in the insurance industry. And I think in the end that regulation is aimed at creating a safety net. And while that is certainly a desirable thing, again as I said before, I think that tends to remove the business incentive that insurance companies have to remain as financially strong as possible. And I think those forces, the business and market forces, in the end are the most powerful tool to prevent insolvency.

Senator BRYAN. Mr. Taub, let me not let you off quite that easy. Mr. Kramer finally came down after expressing some ambivalence, some pluses and minuses on each side of the ledger, that he frankly felt more comfortable—to paraphrase him—probably with the State regulatory system. Let me ask you again more pointedly. Again, not because I have made a judgment in terms of what needs to be done in this area, but to get his record clear. I mean acknowledging some of these problems, and it sounds like you would agree essentially with those five particular provisions that Mr. Snyder shared with us: more frequent financial examination of newer, unseasoned companies; more frequent financial examinations of companies that have high-risk operating characteristics; you know, a more formal and shorter review period of time; stiffer fines and penalties dealing with financial fraud; more standardized risk adjusted capitalization requirements. These are pretty hard to disagree with.

Recognizing that you may not have had a chance to study these; does this make sense?

Mr. TAUB. I think you left out portions of the first recommendation which involved, I believe, ratings more directly in the regulatory process, which, frankly, is something we would tend to disagree with whether it be A.M. Best ratings or Standard & Poor's for that matter. The other suggested improvements in regulation we generally would agree with. I do think it could be handled on the state level with stronger uniformity, which would have to require some additional action by the NAIC.

Senator BRYAN. So, you would also come down in favor of basically retaining the regulatory framework supporting some of these recommendations in terms of more stringent financial standards.

Mr. TAUB. What I would say is that I do think more uniformity is necessary. I frankly do not know whether the NAIC or the current framework can in fact accomplish that. If cannot be accomplished in the current framework, then perhaps some Federal oversight or mandate of that uniformity might be necessary. But I think it is the end result that we would be interested in. Frankly, I am not sure we are in a position to judge which way of getting there would be more appropriate.

Senator BRYAN. Mr. Mayewski, what kind of working relationship do you all have with the State insurance regulators? That is how frequently do you interact with them? Do they call upon you all frequently? Do you make a point of visiting with them periodically? Share with me at least from your company's historical experience.

Mr. MAYEWSKI. I would say that our relationship could be significantly improved and we could work well together. I do not believe right now we have the relationship that we should with the regulators. When we spot a troublesome company we may contact the appropriate State insurance department and discuss the situation. In most cases they do not wish to disclose a lot of information and basically give us just a general overview of the situation. But on a daily, weekly, or monthly basis, we have minimal contact with the departments.

Senator BRYAN. So, it would be fair to say—again to give us just a little sense in terms of the operating relationships, if you see a company that all of a sudden is experiencing what strikes you as the troublesome characteristics or dangerous operating profiles, do you say "Look, we are going to downgrade their evaluation." Do you then on your own, as a company, initiate some type of a bulletin or an alert to the State insurance regulators. Is that a fair description of your company's activities?

Mr. SNYDER. I was going to add that we do communicate with the insurance departments through providing them, free of charge, our publications which include rating monitors, newsletters, 6- and 9-month reviews, as well as annual reviews, of rating changes. So, they are aware of our changes in the judgment that we make in companies that are domiciled within their State.

Senator BRYAN. So, you make available under the circumstances that I am hypothesizing here where a particular company has undergone what you believe is an alarming, or at least a troublesome deterioration, and you are scoring it down in your rating, that type of information is contained in this information that is distributed to each of the insurance commissioners?

Mr. SNYDER. That is correct.

Senator BRYAN. Now, again, Mr. Snyder, a followup to that. To what extent does your company get any kind of a follow up from them? In other words, does Commissioner X in State Y say "Look, I just got this bulletin and you show that ABC Insurance Co. is being marked from a top evaluation to a much more mediocre one"—do they call and say "Look, what does all this mean?" What all do you know that may not be contained in this? What do you think that means in terms of what we ought to do at the State level, what type of precautionary measures does your evaluation suggest ought to be required?

Mr. SNYDER. Mr. Chairman, that feedback from the State does not really exist. There have been some instances where we have been in contact with State departments. But for the most part, the feedback has not been standardized.

Senator BRYAN. A question, if I may, to you, Mr. Kramer, again. To what extent is there a possibility, maybe probability is a more precise term, that if you had a major failure in the insurance industry, that there could be that domino effect that I think a lot of us tend to worry about these days in light of some the experiences in the financial crises that the savings and loan industry has gone through and the problems that the banking industry has experienced. Recognizing that you have made some distinctions between those two, is there a concern—in other words, if you did have one of these collapses on the part of a major carrier, does that portend that there could be a domino effect that would have a much more widespread impact, a rippling effect, if you would?

Mr. KRAMER. I am not sure the notion of a domino effect is particularly apt. On the other hand, if you talk about the structural limitation of this system, and for all defects of the banking system, one way in which the banking system is superior is there is a mechanism to deal with the major financial accident that truly would have systemic implications.

In advance, there is the Fed discount window. And then after the fact, if you have a bank in New England or a Continental, there is a mechanism to control the consequences of that. I made it clear and I want to reiterate, I do not think you are going to have an insolvency of a major carrier. But if you did have such an event, and it is obviously not impossible to have such an event, you do not have a system right now that is geared to handle that. And that is at least a question that one has to think about if you go back to your basic premise and say what is the first job of a financial regulator? It is to avoid shocks to the financial system.

Whatever else they do wrong in banking, the Fed is very good at knowing how to avoid shocks to the financial system. You do not have a mechanism in place to do that for you here. And that relates to the question you were asking about A.M. Best communications with the State regulators. With all due respect to A.M. Best, and however valuable those communications might be, I think that the limits on the information about weak companies is not one of the serious problems for most State insurance regulators now. There will be an occasional really weak department, but by and large, they know who those weak companies are, whether they have as refined an information development system as some private service might have.

The problem is the frequent failure and often inability to act in the event of a weak institution. And the sort of longer term, theoretical if you will, problem is the absence of some sort of mechanism to handle that major accident that you are talking about.

Senator BRYAN. Mr. Kramer, let me just follow up. Assuming for the sake of argument that you did have a collapse of a substantial carrier, and accepting your analysis that there is not the kind of flexibility at least in the insurance system that you have in the financial system for all of the reasons that you have outlined. What is the impact of that? What would happen if it was a substantial carrier that failed? What are the areas of concern? What are the parameters that you see that might raise this to a major public policy issue that would have to be addressed either at the State or the Federal level?

Mr. KRAMER. Well, there are a couple of sides. No. 1, the interrelationships with other companies that they are going to have financial dealings with as would be the case with a bank. There would reinsurance relationships. There are all those other ties that go, you know, among other companies. Under the guaranty system as it is currently structured, I do not know how long it would be taking for people to get their claims paid, which obviously would create problems. And as a matter of fact, if there were to be such an event, in the past there was a very strong impulse within the industry to get together to head it off. And I think that somehow or another the industry and the State regulators would try and find some way, some ad hoc way of heading it off, because the alternative would be something that would be considered unacceptable.

But if it was not headed off and it actually happened, then I think it would end up coming down on the Congress' doorstep because people would say this is a national problem, and obviously you are the only one who is in a position to somehow address it.

Senator BRYAN. Mr. Taub, any comments that you might have under that type of scenario?

Mr. TAUB. Yes. I think I generally agree. Perhaps to your initial question, we have had one case, I guess, in the past year or two which was not an actual failure, but certainly a company with very well publicized problems, and that was Executive Life. Their problems were tied very much to the junk bond market. And in fact you had, in essence, a run on the bank occur there.

But interestingly, even though there were many articles at the time identifying many other companies with significant holdings of noninvestment grade bonds, you really did not have any of those experiencing the same kind of situation that Executive Life did. That does not necessarily mean that you could not have a domino-type effect if Executive Life actually failed or another company had similar problems. But again, even if you look at the various announcements you have had over the past year of large junk bond losses, large real estate or mortgage losses, you really have not seen those announcements cause run-on-the-institution type of results.

Senator BRYAN. Mr. Kramer, you said that profitability in the industry has declined. And I realize that that is a separate issue from the insolvency question, but could you develop that a bit more for us. Is that true in the life-health field as well the property-casualty field? And if so, do you see that occurring for the next 2 to 5 years.

Mr. KRAMER. When you are trying to answer those questions, you have to look at it over a long period of time because of the cyclicality of the business. If you break it down into 5-year aggregates, for the last 15 years, life and health insurance from 1975 to 1979 life and health insurance had a return on equity of 14 percent. For 1985 to 1989, down to 12 percent. A relatively modest decline.

The context for that is that over the same period for the S&P, you are going from 15 up to 16 percent. So, it is below the average for corporate America. On the PC side, although the cyclicality of the industry, two things happen.

No. 1, the cyclicality of the industry obviously makes it critical to take the right time period. And No. 2, the strong stock market and bond market of the 1980's created a lot of capital gains, that unless you believe that trees grow to heaven, you are presumably not going to see every decade.

For the property-casualty industry as a whole, basically there has been—I would say that the normalized rate of return now, and rather than give a lot of figures in my written testimony and the report the committee has, it is all in there—but I would say the normalized average rate of return now for the property-casualty industry is about 9 percent a year return on equity. The average for corporate America is as I say, is about 16 percent a year. And that is lower than it was.

Historically, say in the 1970's and if you averaged in the early 1980's, property-casualty business was a little less profitable than the average business despite the fact that there is more risk in these businesses than there is for the average business. You know, economists will look at it and say well how volatile are the earnings? And theoretically if you had greater risk, it is measured by greater volatility of earnings, therefore you ought have a higher return over time to compensate for that added risk. In fact, what you have got is lower returns than from most industries and higher risk.

I will not go into the details to support that. Over the next couple of years, I think that the—you know the testimony from A.M. Best is as good as you can get, which is that people are expecting that this cycle bottoms out in 1991 or 1992. But I think that until you get past some of the structural problems and get a lot of that excess capacity out of the business, over time you are going to have lousy average returns. Average returns over the cycle of under 10 percent a year, which is one way of not attracting new capital to the business.

It is also, by the way, I should add, a risk factor, just as it was for the S&L's. When people get in trouble, and actually, it is the same thing that happened in the banks in the mid-1980's, when returns go down on your core business for whatever set of reasons, there is a tendency to take greater risk, to look for new things to do or to pile on in some area that has got a high return over the short term because there is this great pressure to report earnings, adequate earnings, over the short term. So, I consider the inadequate profitability of the industry another risk factor.

Senator BRYAN. I thank you very much and as I suggest that it is not often that a marriage between the banking industry and the insurance industry is one that necessarily is made in financial heaven from what you have indicated. I appreciate very much your testimony, the testimony of Mr. Taub, Mr. Mayewski, and Mr. Snyder. You gentlemen have been very helpful to the committee. We thank you very much.

The next panel will consist of Mr. Jim Barrese, Associate Professor of Economics, the College of Insurance of New York, and he will be joined by Dr. Jack Nelson, Marty Leary, the Research Director of the Southern Finance Project, and Mr. William H. McCartney who is the vice president of the National Association of Insurance Commissioners.

Gentlemen, welcome to the committee. We will hear first from Mr. Barrese.

STATEMENT OF JIM BARRESE, ASSOCIATE PROFESSOR OF ECONOMICS, COLLEGE OF INSURANCE OF NEW YORK; ACCOMPANIED BY JACK NELSON, ASSOCIATE PROFESSOR, COLLEGE OF INSURANCE OF NEW YORK, MARTY LEARY, DIRECTOR, SOUTHERN FINANCE PROJECT, WILLIAM H. McCARTNEY, VICE PRESIDENT OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. BARRESE. Good morning. Jack Nelson and I would like to split our remarks. I will speak of the current financial condition and trends of the insurance industry and then discuss the consequences of insolvency, who pays the cost.

Senator BRYAN. That would be fine. Let me make you conscious of the fact that you can submit your full text.

Mr. BARRESE. These will be summaries.

In recent times the insurance industry has been scrutinized for fears that it may be the next savings and loan crisis in the making. With the caveat that crisis depends on one's perspective, our investigation of the trends in the insurance industry causes us to conclude that the insurance industry is not now facing a crisis but that the trends are not positive.

For example, in 1988 there were 569 insurers designated by the NAIC as being in need of regulatory attention while just 9 years earlier in 1979, there were 132. Additionally, what is typically viewed as one measure of the cost of insolvency, the level of guaranty fund assessments, have increased tenfold in the past 10 years. Nonetheless, at current assessment levels, it would take centuries to exhaust the industry's surplus. We conclude that a current problem does not exist for the industry as a whole.

The fact that the industry as a whole is not in danger, however, is less relevant than the fact that the cost of insolvencies appear to be increasing, and increasing more rapidly than personal income.

Because the cost of insolvencies is largely borne by taxpayers and consumers, the current patterns imply that insolvencies will be absorbing increasing portions of society's disposal income.

When an insurer becomes insolvent, most of the claims against the insurer by the insureds, are paid out of a State-run guaranteed fund. The moneys for the fund are raised by assessing existing insureds. The funds do not cover all claims and limits exist on the maximum amount per claim which is recoverable; these costs of insolvency are not included in the typical measure of cost, the guaranty fund assessment. It is frequently suggested by surviving insurers that they pay the cost of insolvency twice, first when they lose market share and then when the cost of that business is paid for by them in a guaranty fund assessment. This view neglects to observe that the owners of the insolvent firm lose their investment, that some of the firms' insureds are not fully protected by guaranty funds so they bear some of the cost, and significant portions of the fund assessments are shifted to taxpayers and consumers.

Guaranty fund assessments are deductible from Federal taxable income, so to a degree the assessment is shifted to Federal taxpayers. In addition to distributing that by income class, it means that an assessment paid for an insolvency in one state is shifted to taxpayers in other States. In addition, at least-30 States make provision for State tax credits that further offset the portion borne by insurers.

Finally, to the degree that existing insurers are bearing a residual cost, they are encouraged to recoup the guaranty fund assessments in rates.

From our studies to date, we conclude that the conditions in the insurance industry are ripe for what economists described as a Pareto of optimal improvement. An improvement in regulation may reduce the need for assessment funds; this will reduce the payments taken from taxpayers and consumers. The savings of improved regulation may be more than sufficient to offset the increased costs of regulation.

The specifics about which States, how many have different types of credits, and so on, are in our written testimony. Dr. Nelson will speak to the causes of insolvencies and solution that we suggest.

Senator BRYAN. Dr. Nelson.

Dr. Nelson: Thank you. As Dr. Barrese was saying, our view is that the industry is not currently in a crisis situation. I know you have heard a lot of testimony this morning and I think there is something of a consensus that the life and health insurance industry is probably not under as much distress as the property and casualty industry. So, I will restrict my comments, for now, to the property-casualty industry.

We think the current regulatory system has been adequate on the property-casualty side. The NAIC has initiated numerous improvements to the regulatory structure that we think hold a lot of promise of succeeding. We think that the conclusion from a Federal point of view is that significant Federal involvement, at this point, is probably premature.

However, as was mentioned in our remarks, we feel that the threat of Federal intervention into the insurance regulatory arena has been helpful in times past in motivating the various States to coordinate their efforts and to make regulatory improvements. Therefore, we would like to propose that Congress institutionalize a threat, of sorts, to the current system.

The reason we would endorse a Federal threat is that, unlike some of the other testimony that was offered here, we feel that there are various economic trends, and the business environment is such, that we expect to see a continued rate of insolvencies in the property-casualty industry like we are seeing now, and possibly an increase.

Before I describe those trends, let me just point out that there is a remarkable difference between personal lines markets and commercial lines markets. For the most part, I am restricting my comments to the commercial lines market here.

There have been increases in the underlying costs involved in insurance. A few years ago we used to talk about the increasing costs on the liability side, with all of the various things that have happened on that side, with malpractice, and products liability, and environmental impairment, and this kind of thing. But recently we have also seen real problems on the property side as well. We have had some tremendous wind storm losses in Europe. Hurricane Hugo was another example of big property losses. And so there are problems with the underlying costs, and we are seeing more volatility than we thought we had there.

Alternative risk financing mechanisms are more in vogue. We are seeing large firms retain more of their exposure. We have seen them use different types of risk financing organizations. There are a lot of estimates that suggest that 30 to 40 percent of the commercial property and casualty market is outside of the traditional insurance market now and in some sort of alternative risk financing mechanism. As those continue to proliferate it becomes more difficult for the property and casualty commercial insurance industry to ever make adjustments and raise prices because there is a ready substitute waiting to be used to finance risks.

There has been foreign entrance into the U.S. market and there are a couple of examples cited in our report. Therefore, we feel that there will be continued pressure on the commercial, property, and casualty carriers to reduce their costs and to lower their margins. As a result we expect those players that are slower than the others, to fall by the wayside. And we expect to see insurance company failures.

Our view of what the regulatory objective should be is consistent with what has been mentioned earlier, and that is, that rather than the regulatory focus being to prevent failures, if we should prevent the policyholder losses associated with those failures In conjunction with that, we propose that the standardization and quality of regulation be improved. In addition, we propose that congressional oversight of insurance regulation be institutionalized.

Our proposal revolves around the concept of a centralized solvency surveillance agency. We have not really detailed how this would work in terms of its place in the current regulatory structure. It could be a self-regulatory organization, something like the NASD. Or it could be an organization that is affiliated somehow with the NAIC, some sort of a standing taskforce. But somehow this empowered agency would exist and its mission would be to assist State regulators in the insolvency policing of multistate insurance companies. The mission of the centralized agency would be to only look at multistate insurance companies. The agency would require information from insurers and then produce information with regard to their financial standing.

In addition, the centralized agency should be given authority to do something similar to what the NAIC is doing now with their certification process. And that is, they would certify State response to the information provided by the agency with regard to solvency. In other words, if a State reacts promptly to information provided by the solvency agency, then they would be given a good rating. Whereas, if they did not and they delayed in taking remedial action with a distressed insurance company, then they could, perhaps, lose their certification. Unlike the current NAIC proposal, we think that it would be helpful to actually legislate some type of penalty for states that lose their certification. And so, we suggest, that insurance companies domiciled in States that are not certified by the solvency agency, be prohibited from writing insurance in other States until the State's certification was remedied.

We would hope that the centralized agency would be able to assist in the timely removal of distressed insurance companies and as a result, achieve some of the goals that Dr. Barrese spoke of.

In addition, we would also like to propose that market forces be kept intact and that sophisticated buyers—this would be large, commercial insurance buyers—be exempted from any type of guaranty fund protection so that they would continue to have an incentive to carefully select their insurance company. In addition, agents and brokers who are selling to sophisticated insurance buyers, should be given some type of protection so that the cost of insurance company insolvencies are not shifted to the liability carriers of those agents and brokers.

We feel that some type of a Federal legislative action is necessary because of the timeliness that can be accomplished with a Federal initiative, and to insure that adequate resources are provided to the centralized agency.

Thank you.

[The prepared statement of Mr. Barrese follows:]

PREPARED STATEMENT OF JAMES BARRESE

Our names are James Barrese and Jack M. Nelson. We are Associate Professors at The College of Insurance. Thank you for the opportunity to comment before the Consumer Subcommittee. Our comments will focus on three topics:

- the financial condition of the insurance industry,
- the underlying causes of the growth of insurance insolvencies,
- and the impact of insolvencies on taxpayers and consumers.

These issues are addressed after presenting an overview of aspects of insurance regulatory history; aspects which we believe to be relevant to the current discussions concerning reform of the insurance regulatory structure.

Based on our studies to-date, we conclude that the insurance industry is not now in a crisis situation but that the trends are not positive. We conclude that the causes of insolvency in the insurance industry include problems of regulatory oversight, isolated cases of company mismanagement, and the impact of exogenous forces. In our opinion significant attention has been given to the first two causes and not enough to the latter. Regulatory improvements can be made to catch mismanagement problems earlier and to better integrate the effect of economic, legal, and industry forces on the problem of the timely detection of troubled firms.

Finally, we conclude that as much as 66 percent of the total cost of insolvency may be shifted from firms to taxpayers with an additional, as yet undetermined amount being shifted to consumers in the form of higher insurance rates. An additional cost is borne by the insureds of the defunct firms. The remaining cost of insolvency, which is borne by existing, solvent firms, has a negative influence on insurance availability.

We are now in a situation in which the possibility of a gain may exist for all parties. An improvement in regulatory oversight is likely to result in a reduction in the need for assessments. The associated tax and insurance costsavings could more than offset the increased regulatory cost.

ASPECTS OF INSURANCE REGULATORY HISTORY

Individuals and firms purchase insurance to obtain financial protection. A premium is remitted to an insurer in return for a promise that the insured will be indemnified, according to the insurance contract, from a financial setback occasioned by certain specified events. In the United States, a system of insurance regulation has developed to ensure that insurers will have the wherewithal to satisfy their promises.

Typically, the regulatory process involves oversight of insurance company operations and the imposition of limits on behavior. Regulators also impose procedural and accounting rules to ease and improve the regulatory process. The limits and oversight are designed to reduce activities which are deemed to put at risk the ability of an insurer to meet its promises. The limits and rules for oversight include minimum capital and surplus requirements, limitations on acceptable investments, marketing practices, and growth rates; the rules address such topics as the acceptable insurance accounting practices.

When the oversight portion of the State regulatory system does not suffice to keep an insurer whole, the remainder of the industry is called upon to guaranty payment of the promises of the insolvent insurer. This function is currently performed through the use of State insurance guaranty funds.

The current regulatory structure has evolved, in part, through the uncoordinated efforts of the States. Some coordination and uniformity among States have been achieved through the actions of the National Association of Insurance Commissioners (NAIC). But, these actions, indeed, even the creation of the NAIC have frequently been the result of efforts to stem a threat of Federal intervention.

THE FINANCIAL CONDITION OF THE INSURANCE INDUSTRY

The primary responsibility for solvency regulation of an insurer has traditionally rested with regulators in its domiciliary State. However, many States have placed increasing reliance on the NAIC to perform the first steps in identifying firms most in need of a solvency review. The NAIC's method of determining firms in potential difficulty, however, has been criticized as being overly broad. Recent years have seen almost one in five insurers identified as being in need of further attention. In 1988 there were 569 insurers designated by the NAIC as being in need of regulatory attention, while just 9 years before in 1979 there were 132. Nonetheless, these statistics are cited as evidence of increasing solvency problems in the insurance industry.

Every firm, regardless of the industry, lives with the possibility of failure. When an industry is deemed to be vested with the public interest policymakers seem to develop a more intense interest in the industry; insurance is such an industry. In the case of insurance company solvency the question is, Is the probability of failure sufficiently low to allow public policy to concentrate on other issues? Unfortunately, the question is complicated by the size of large insurance groups. If only one large insurance group were to fail the consequences for all other insurers, for the economy, and for taxpayers and consumers are likely to be significant. For this reason, it is suggested that the socially acceptable probability of failure decreases with increases in firm size. The socially acceptable probability of failure is currently determined in the political processes of the various States; target and actual probabilities are not given by State regulators.

Recent insolvency experience appears to raise the issue of whether the trend of insolvencies has increased in recent years, either in terms of the number of insolvencies, the size of insolvencies, or both. Table I summarizes these recent trends (assessments and surplus in millions).

TABLE I

Year	Property and casualty			Life and health		
	No. of failures	Guaranty fund assessments	Surplus	No. of failures	Guaranty fund assessments	Surplus
1979	9	64.3	42,456	7	9.7	28,073
1980	6	14.4	52,196	5	3.7	32,274
1981	2	30.9	53,805	5	7.4	35,211
1982	3	49.1	60,395	4	8.2	39,105
1983	7	42.5	65,606	8	57.9	43,978
1984	27	120.5	63,801	6	30.1	47,800
1985	26	316.0	75,511	12	20.1	54,039
1986	26	436.9	94,288	12	15.8	61,314
1987	15	899.1	103,996	19	90.5	64,496

TABLE I—Continued

Year	Property and casualty			Life and health		
	No. of failures	Guaranty fund assessments	Surplus	No. of failures	Guaranty fund assessments	Surplus
1988	21	518.1	118,195	13	78.8	72,021
1989	43	901.7	133,972	43	161.1	80,613

SOURCES.—National Committee on Insurance Guaranty Funds, National Organization of Life & Health Insurance Guaranty Associations, A.M. Best Company, New York State Insurance Department. Note that the high number of life/health insolvencies in 1989 is caused, in part, by a change in the defined minimum capital requirements in Texas. In 1989, 14 life/health insolvencies occurred in Texas.

Guaranty fund assessments are a measure of the cost of an insolvency. The aggregate annual amount assessed for claims made against insolvent firms in a particular year, regardless of the year of insolvency, is often described as the cost of insolvencies occurring that year. For example, one sometimes mistakenly infers that the 43 property and casualty insolvencies occurring in 1989 are associated with the $901.7 million guaranty fund assessment. The values are, of course related, but not so precisely. The aggregate amount paid in a particular year by all firms in the industry is less relevant than the amount paid on a particular insolvency over time. Nonetheless, the pattern of annual guaranty fund assessments is frequently cited as evidence of the size of insolvencies. Commentators observe that this measure of the size of insolvencies, as well as the number of insolvencies, has increased dramatically in the 1980's.

The increase in the number and relative size of insurance insolvencies, on the heels of the S&L crisis, have heightened concerns over the financial strength of the industry. However, it does not appear that the industry as a whole is in danger. At current levels, the ratio of guaranty fund assessments (GFA's) to surplus suggests that it would take centuries to erode industry surplus. Nonetheless, the patterns are not pleasing. In 1979, the ratio of GFA's to surplus suggested sufficient surplus to make that level of payment for over 900 years. In 1989 it would take 200 years to exhaust surplus and if the growth rate of GFA's continues to exceed the growth of surplus the cushion of surplus will be more rapidly eroded. Moreover, the fact that the industry is not in danger of collapse is less relevant than the fact the costs of insolvencies appear to be increasing and increasing more rapidly than personal income. Because the costs of insolvencies may be borne by taxpayers and consumers the current patterns imply that insolvencies will be absorbing an increasing portion of society's disposable income.

There have been frequent comparisons made between the financial condition of the banking and thrift industries and the insurance industry. Many of these discussions have compared the apparent similarities between insolvencies in the insurance industry and insolvencies in the banking and thrift industries. It should be noted however, that just as the basic solvency problems far thrifts differ from those of commercial banks, the solvency problems of property and casualty insurance companies differ from those of life insurance companies.

In property and casualty insurance the solvency concern has focused on the adequacy of insurer reserves. Inadequate reserves result in understated liabilities and overstated surplus levels. The adequacy of reserves have dominated solvency discussions thus far because of the magnitude of some of the more recent insolvencies and the resulting guarantee fund assessments. In life insurance, the concern has centered on falling asset values.

While the magnitude of the insolvency problem is much lower in the insurance industry than it is in the thrift industry, it is instructive to review two similarities. One of the primary causes of S&L failures was mismanagement. The managers of the S&L's made loans in areas where they had little or no previous expertise. Some insurance companies have followed a similar path. The Transit Casualty Insurance Company, one of the larger insolvencies, traditionally insured trucks, buses and transit companies, hence its name—Transit Casualty. The managers of Transit then diversified the liability portfolio to include insurance for chemical companies, drug manufacturers, asbestos manufacturers, satellite launches, toxic waste sites, and racehorses. These areas of insurance were well outside the traditional field of expertise for Transit Casualty.

Accompanying mismanagement in the S&L industry was intense competition to attract money that could in turn be loaned. Troubled S&L's bid up the cost of attracting deposits and otherwise healthy institutions had to follow or lose market share. The same occurs in the insurance industry. The intense competition that exists in the commercial property and liability insurance markets forces the managers of healthy insurers to follow troubled insurers and reduce the price of their insurance, or potentially sacrifice market share.

UNDERLYING CAUSES OF THE GROWTH OF INSURANCE INSOLVENCIES

Each State sets minimum required surplus levels for insurance companies. An insurer is insolvent when the sum of its liabilities and the minimum required surplus level of its domiciliary State exceed its assets. Insolvencies of property and casualty insurers have typically been triggered by the realization that liabilities are understated. Insurers can also become insolvent if the value of their assets decreases, while liabilities remain unchanged, resulting in a surplus level below the required minimum. Increases in liabilities which are predicted are generally incorporated into insurance rates. Insurer insolvencies are caused by unexpected increases in liabilities or unexpected decreases in assets.

The Dingell Committee report, "Failed Promises," leaves the impression that the primary causes of two large recent insolvencies were management nefariousness and negligence. That is, liabilities were intentionally or negligently understated. If the managers of failing insurers desire to hide that weakness, from themselves as well as others, it is not very difficult to do so. "Failed Promises" illustrated that the deception cannot continue indefinitely and, when discovered, the reported liabilities of an insurer can increase quickly. The relatively small number of insurer insolvencies to date relative to the size of the industry provides some evidence that insurers have not been systematically victimized by unscrupulous managers.

Rather than unscrupulousness or incompetence, adverse economic and industry trends are more likely to be factors in future insolvencies. For property and casualty insurers, these trends include:

- *Increases in the underlying costs of insurance.* Unlike life insurance where improvements in average mortality can work in favor of the insurer, the costs of property and liability insurance seem to be increasing faster than expected. Particularly difficult areas of liability insurance include coverage for products, pollution, medical malpractice, and directors and officers liability. Problems have also surfaced in property insurance. For example, the wind storms that occurred in Europe in 1987 and 1990 were expected to be events occurring, at most, once every 20 years. The storms feed fears that weather patterns have changed or have not been sufficiently understood.
- *Increases in the use of alternative risk financing mechanisms.* Firms that formerly financed most risk exposures by purchasing insurance have been purchasing less insurance. Rather than purchase insurance, firms have been retaining larger amounts of their risk. When managers decide to retain risk, they typically begin by retaining the risks with the most predictable losses. The remaining demand for insurance is for less predictable risks. This change in the pattern of insurance purchasing increases the unit cost of the insurance purchased. Yet, the increased sophistication of insurance buyers places limits on the insurers ability to raise rates. Increasing insurance rates induces managers to select further alternative risk financing mechanisms rather than purchase insurance.
- *Increased participation in the U.S. insurance markets foreign insurers.* Recently Fireman's Fund and The Home insurance companies were purchased by German and Swedish insurers. In addition, other foreign insurers have applied for licenses to operate within the United States. This introduction of additional insurers increases the amount of capital potentially committed to the U.S. insurance market. In an era of reduced profit margins occasioned by the sophistication of buyers, companies are also facing increased potential competition. Potential competition serves as an additional factor limiting the insurers ability to raise rates.

These trends will result in the elimination of property/casualty insurers unable or unwilling to compete with lower profit margins. The solvency problems experienced by life insurers, on the other hand, have resulted, in part, from the following trends:

- *Decreased value of bond portfolios composed of low grade or junk bonds.* As more firms defaulted on their junk bonds, the value of these bonds decreased. This decrease in asset values resulted in a decrease in insurer surplus.
- *Decreasing real estate values.* The falling values associated with depressed real estate market have also resulted in reduced values of insurer surplus.
- *Temporary increases in life insurer liabilities due to increased mortality from insureds with AIDS.*
- *Steadily increasing liabilities associated with health insurance.*

Life insurers and regulators have taken steps to reduce holdings of junk bonds. These responses to changes in the valuation of bonds, combined with the eventual recovery in the real estate markets should greatly reduce the danger of insolvency to life insurers. While there was some initial concern in the life insurance area regarding increases in mortality due to AIDS, life insurers seem satisfied that the problem has been addressed by changes in underwriting standards. Because increases in health insurance costs are more quickly known than the increases in the cost of liability insurance, health insurance rates can rapidly increase. The increased health premiums reduce the likelihood of insolvency caused by unexpected health liabilities.

THE IMPACT OF INSOLVENCIES ON TAXPAYERS AND CONSUMERS

The position of Government regulation has been that policyholders of insurance companies will not suffer the financial consequences of a failure of their insurer. Since the 1970's the initial impact of insolvencies has been paid for by surviving insurers through the use of guaranty fund assessments. Some guarantee fund protection existed prior to the 1970's but these funds proliferated following the adoption of an NAIC Model Guarantee Act in 1969.

Guaranty Funds. Unlike the Thrift industry, with which the solvency of the insurance industry is frequently compared, there is no explicit Federal protection for policyholders. Instead, in every state, claims against insolvent insurance companies are covered by State guaranty funds. When a company doing business in a State becomes insolvent and cannot pay outstanding claims, the State guaranty fund monies are used to satisfy the outstanding and future claims against the insolvent insurer. Like Thrift protection, there are limits to the protection afforded by guaranty funds. Claims may be subject to a deductible (typically $100) and, in most States limits also exist (typically $300,000 per claim). In addition, some lines of business are not. covered by guaranty fund protection. Moneys for the guaranty funds are raised by assessing insurers doing business in the State.

Initially, the guaranty funds offered protection to policyholders of only certain lines of insurance, typically auto insurance, but soon spread to other lines. However, State guaranty funds cave not expanded to completely cover all lines and all insureds. For example, most funds exclude from coverage reinsurance and surplus lines insurance.

The NAIC has adopted two "Model Acts" pertaining to guaranty funds: the Post-Assessment Property and Liability Insurance Guaranty Association Model Act (1969), and the Life and Health Insurance Guaranty Association Model Act (1970). Most States have adopted, in whole or in part, laws based on or similar to the NAIC model acts. A history of the dates of initial State action on these model acts is provided below. For the property/casualty side of the insurance business, most States adopted legislation based on or similar to the NAIC Model Act in the 1970's; the bulk of life and health coverage began in the 1980's.

TABLE II—State Action on Guaranty Fund Laws

	No. of States	
	Life/health	Property/ casualty
Year of action on NAIC Model of GFA Acts:		
1970–74	9	30
1975–79	10	4
1980–84	8	5
1985–89	17	7
1990–91	3	0
No, or prior State action	4	5

Source.—Compiled from NAIC Model Regulation Service, July 1988.

Many commentators on the guaranty fund payments take a view that these payments are borne by the surviving insurance companies. Such commentators typically argue that "the stronger firms pay twice - once in the marketplace through stiff competition from these formerly aggressive companies, and again through their guaranty fund assessments."[1] This view neglects to recognize that significant portions of the payment made by insurers to a guaranty fund are shifted to taxpayers and consumers. Indeed, the comments provided along with the Life and Health Insurance Guaranty Association Act state that: "Participation in the economic loss would be shared to some degree, by the general public rather than solely by insureds." No mention is made of a portion of the GFA being borne by insurance companies, though, of course, a portion is.

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[1] Vogel (1991, p. 20).

Guaranty fund laws in many States include a provision that allows insurers to recoup assessments in subsequent premiums. Some States permit explicit premium surcharges. Additionally, most States and the Federal government allow guaranty fund deductions from corporate income taxes and permit credits against taxes on premiums. This is not to say that insurance companies are protected from the financial consequences of the insolvency of a competitor. However, the actual impact of a one dollar guaranty fund assessment on an insurer is likely to fall short of one dollar. How far short depends on the State in which the assessment is made; that is, on the tax credit and rate setting policies of the State, and on interactions between the Federal tax and State tax provisions.

Tax Offsets: Federal. State insurance guaranty fund assessments are allowable as a deduction in deriving Federal corporate taxable income. If an insurance company pays Federal taxes, 34 percent of the assessment has been offset through a reduction in Federal taxes. Even if the company pays no current taxes it may carry losses to future tax years, including those losses attributable to the GFA. If the firm is ever profitable it will benefit from the deduction, though the foregone investment income on the tax benefit will reduce the value of the offset.

The deductibility of the insurance guaranty fund assessment from Federal taxable income, like any other deduction, causes the Federal Government to place greater reliance on other revenue sources than would be the case absent the deduction. In essence, 34 percent of the guaranty fund assessment may have been shifted to Federal taxpayers. Taxpayers will bear these costs in accordance with the distributional impact of the Federal revenue system. Moreover, to a degree, an assessment in one State will be shifted to taxpayers in other States.

Tax Offsets: States. Most States impose corporate taxes on insurance firms which involve more than one tax base. Typically, the taxes involve an income base, a capital base, a premium base, and a fixed dollar amount, with insurers paying the highest of the taxes computed on the alternative bases. Evidence suggests that insurance companies most frequently pay the tax computed on the premium tax base.

To the degree that the States adopt Federal taxable income as the starting point in determining State taxable income, and to the degree that insurance companies pay on the income base, the States may also be underwriting a part of the assessment. However, as noted above, most insurance firms pay State taxes computed on the premium rather than on the income tax base.

Thirty States make a provision for a credit against their premium tax which is a fraction of the firm's guaranty fund assessment. Some of the States allow a credit for both life and health as well as property and casualty assessments while others restrict the credit to only one of the sides of the industry. Twenty-seven of these States allow a full credit, though the credit, typically, is distributed over a period of time. Some of the States allow the credit only for life/health assessments and some of the States limit the credit to assessments for a subset of contract types, other States allow the credit only for property/casualty assessments, and one spreads recovery over different time periods depending on whether the assessment is on the property/casualty or life/health sides. The modal credit scheme allows the firm to offset against the premium tax 20 percent per year for each of 5 years. This 20 percent for 5 years credit is the suggested (optional) credit in the NAIC Model Act.

Table III provides an overview of premium credit rules in the fifty States and the District of Columbia. The information is presented for each side of the industry.

TABLE III—State GFA Tax Credits Available

Credit description	No. of States	
	Life/health	Property/ casualty
100 percent in the assessment year	10	7
20 percentper year for 5 years	16	*11
50 percentin the assessment year	*2	0
40.366 percent in the assessment year	1	1
0.1 percent per year	1	1
No credit	21	31

SOURCE.—American Insurance Association, State Taxation Manual, 1991 (laws as of December 1990). Note that one State offers a different credits (asterisked) to its Life/health and Property/casualty insurers.

Table IV was developed using the information summarized in table III, the amount of 1989 guaranty fund assessments, in each State, and an initial assumption that firms pay State taxes only on the premium tax base. This yields an estimate of the maximum amount of assessment which may potentially by offset by existing State tax credit laws. Additional limitations include: Federal and State interaction affects are not considered, and the estimates ignore the fact that the credits on the life and health side are frequently limited to particular contract types. Finally, the estimates also ignore the reduction in the present value of the credits for those credits which are spread over a period of years.

TABLE IV—Analysis of 1989 Guaranty Fund Assessments

	Life/health	Property/casualty
GFA's	161.1	909.7
Federal tax rate offset (percent)	34.0	34.0
Estimated State credit offsets (percent)	42.9	29.6

SOURCE.—Authors calculations. Subject to the caveat that the percentages cited are the result of an ongoing research and are subject to change. They are given in percentage rather than dollar terms to minimize the potential misuse of estimates which are preliminary.

The estimates provided above suggest that 34 percent of the assessments are shifted from insurance corporations to Federal taxpayers. Distributionally, the cost would be borne in accordance with the distribution of the Federal tax system—geographically as well as over the range of income. Additionally, a weighted average 31.6 percent of the total life/health and property/casualty assessments is estimated to be shifted from insurance companies to taxpayers in States offering guaranty assessment fund tax credits. If there is no Federal provision made for credits given at the State level, the total average offset approaches 66 percent. The actual average Federal and State offset most likely falls in the range from 34 to 66 percent. Of course, the estimate for a particular State will range from a minimum of the 34 percent Federal offset to a possible combination of 134 percent: the sum of the Federal offset and the maximum State credit of 100 percent.

The tax payments by insurers before considering a tax offset would be available to finance a mix of government goods and services. The information provided in table IV suggests that an additional dollar of guaranty fund assessments would cause 34 cents to be reduced from Federal tax revenues and an average of almost 32 cents to be shifted from general fund revenues at the State level. At the State level the shifted funds are dedicated to a particular purpose: payment of a claim against an insolvent insurer. Like the options facing the Federal Government, to maintain a balanced budget State governments would face the choice of raising other State taxes, increasing borrowing, or reducing services.

Rate Increases.—Federal and State tax offsets, however, are not the end of the story. The NAIC Model Act for property and casualty assessments, in section 16, provides that rates "shall include amounts sufficient to recoup a sum equal to the amounts paid to the Association." The impracticality of recouping assessments against existing life and health contracts explains the fact that 11 of the States allow credits for life and health assessments only.

The NAIC does more than simply state that firms can attempt to recoup assessments in the form of higher rates, it provides model regulations with instructions for how to compute the recoupment. That is, in 1972, an NAIC task force was empowered to create a recoupment formula under the model law. The task force made the following recommendations:

"(1) In making rates consideration should be given to past assessments paid. It is the intent of the guaranty fund law that the assessments are to be borne by the policyholders eventually through their premium payments. (2) The language is quite clear on the point that, if assessments have been paid, rates are not to be considered excessive because they contain an amount to recoup the assessments paid. Because rate-making is prospective in nature, the rating law requires that due consideration be given to prospective expenses as well as past experience. (3) The task force recommended numeric formulas considering available information from prior insolvencies covered by guaranty funds. (These are found in a note at the end of the model.)"[2]

The number of States with recoupment provisions and the estimated amounts recouped are the subject of continuing study. However, it is virtually certain that a percentage of the assessment which is not offset by tax deductions and credits is offset trough rate increases. These provisions result in the potential transfer of significant portion of a guaranty fund assessment to future insureds.

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[2] NAIC Model Regulation Service, July 1990, p. 540–28.

CONCLUSION

A recent Insurance Information Institute publication carried a preface which states: "While insurer insolvencies remain well below the levels recorded by other major sectors of the financial services business, they have risen in recent years, and there is no evidence that the trend is about to reverse itself. But increased financial strain should not be confused with an insolvency."[3]

The likelihood of an impending crisis depends, in part, on how crisis is defined. If the annual failure of 1 to 2 percent of the insurance corporations may not seem significant to survivors in the industry. On the other hand, if the cost of the insolvencies is being borne by individuals who do not otherwise gain from the acceptance of the insolvency risk—taxpayers—the crisis may already be upon us. Taxpayers and insureds bear the bulk of the Cost of insolvencies, not surviving insurance firms. For Contracts which are not covered by guaranty funds, as well as claims exceeding the limits of guaranty funds, the insureds of the insolvent firm pay the cost of insolvency. Of these costs initially borne by remaining insurers, significant portions are shifted to taxpayers and future insureds. Only the residual portions of guaranty fund assessments remain with the insurer bearing the initial burden.

The costs of insolvency remaining with an insurer are likely to have both direct and indirect effects. Among the direct effects, the profits of insurers may be reduced, the taxes paid for by insurers will be reduced, and industry concentration may be increased. Among the indirect effects, the availability of insurance will be impaired. That is, the rate of growth of insurance company surplus is positively related to profits. A GFA will, to a degree, reduce profits and, therefore, the rate of surplus growth. Insurance availability, in turn, is positively related to company surplus. A reduction in the rate of growth of surplus, caused by a GFA, will tend to constrain the growth of insurance availability. This negatively affects the quantity of activities in which society will engage.

Improvements, many argue, will only come with Federal involvement in the regulatory process. Others suggest that Federal regulation is less than perfect and that most improvements suggested by critics have been recently enacted at the State level. Critics of Federal involvement also point to the recent efforts of the NAIC to achieve coordination and uniformity of State action. The NAIC has a history of developing model regulations and acts which will lead to improvements in insurance solvency regulation. States, however, have little incentive and no requirement to adopt these model regulations and acts. State coordination and uniformity of action appears to come in waves. These waves are typically preceded by the threat of Federal intervention. Rather than a full Federal regulatory agency, the institutionalization of a Federal oversight role may be sufficient to accomplish the objective of ensuring the continued improvement of insurance regulation.

Proposed Solution.—Recent proposals for regulatory change made by the NAIC would improve solvency policing. If enacted, these proposals will result in improvements in the quality and quantity of reported financial data. While the financial condition of the insurance industry does not currently warrant radical modifications to the regulatory structure, it is possible to effect structural changes to minimize the cost of future insolvencies.

Solvency surveillance can be significantly improved through the use of a central regulatory agency. This is not a call for the creation of a new Federal agency that would interact with the insurance companies and State regulators. The addition of Federal regulation would be unlikely to replace State regulation. The resulting combined system would increase the cost of regulation but would not provide a certainty that improvements would occur.

There is little reason to believe that, with the partial exception of uniformity of rules, Federalizing regulation will improve the process of monitoring insurer strength. This is especially true in the short-run as a new Federal agency would be forced to hire from the existing pool of qualified personnel. As these individuals would likely come from State insurance departments and insurance companies, the introduction of a new Federal agency would result in a short-run dilution of the regulatory ability to police insurer solvency. Moreover, depending on the relationship between Federal and State laws, the benefits of uniform national rules could be reduced by a cornucopia of additional State rules.

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[3] Moore, in Kramer, 1991, p. viii.

The proposed regulatory system addresses the problem of monitoring solvency through the empowerment of a centralized agency to work with the States in policing solvency. This system would allow the centralized agency to assist the State regulators in dealing with the solvency issues of larger, multistate insurers and reinsurers. State regulators would retain exclusive control over issues of policy structure and form, and over the solvency policing responsibilities for intrastate insurers. The system would provide consumers with the best of the current system, regulatory flexibility to reflect local needs, and improved solvency surveillance. Insurers and reinsurers would also benefit by facing a more consistent review process, without worry about the possibility that a Federal, as well as each of the State regulators will attempt to perform the same function, using different standards.

The centralized agency would be responsible for setting financial standards for insurers that operate in more than one State and for monitoring insurer compliance with those standards. The various insurance departments would be responsible for the same functions pertaining to insurers operating solely within their jurisdiction, and for enforcement of the standards upon multistate insurers that are in violation of the national standards. The centralized agency would also certify the various State insurance departments based on their effectiveness in specified areas, including solvency enforcement.

State certification is necessary to provide a market incentive for efficient enforcement of solvency standards, and for sufficient funding of the State insurance departments. Certifying results of solvency enforcement rather than the methods of enforcement allows for the benefits of regulatory variation which now exists while providing State conformity with regulatory standards. Insurers domiciled in States not certified by the centralized agency would be prohibited from writing new policies in other States until it could be shown at a hearing that the lack of certification was an error or the deficiencies have been corrected. That is, the agency would develop requirements for State certification and insurance company operation.

State certification would be a function of, for example, State laws regarding insurer solvency policing, the treatment by the State of domiciliary multistate insurers which have been liquidated, the degree to which insurance consumers have been protected from the financial consequences of insurer insolvencies, and the vigilance of prosecuting criminal behavior of insurer managers and the recovery of assets from those individuals convicted of criminal behavior. A Congressional committee, such as this Senate Subcommittee, would be responsible to check the sufficiency of the agency's consistent application of certification standards. Federal legislation is necessary to empower a centralized regulator to monitor solvency and to provide it with the authority to certify State solvency policing.

There are two additional reasons for suggesting that Congress empower a centralized solvency agency under its direction. The first reason is that Federal legislation offers a method of initiating this proposed system within an acceptable time period. This proposed solvency task force could be voluntarily empowered by the various States. However, the evidence of almost 50 years of NAIC activity, indicates that the States frequently choose to not adopt NAIC recommendations, or those recommendations are altered according to each State legislature. Consequently, Federal legislation is required to complete the empowerment in a timely fashion.

The second reason compelling a Federal initiative is to ensure that sufficient resources are committed to the task force. Lacking a required commitment by the States, or a commitment of funds by the Federal Government, the task force would be doomed to failure. Congress faces a difficult task: to fund a new agency in an age of budgetary deficits. This problem is made more difficult since many believe that the financial condition of the insurance industry is not yet a crisis. However, a solvency crisis in the insurance industry could be reduced by improving the current system of solvency policing. Additionally, many States also have large deficits and would not be expected to respond favorably to a mandated expenditure for a national regulatory group.

While this paper offers no suggestion about the financing mechanism, it is suggested that this regulatory alternative minimizes the need for additional regulatory costs. One way costs are minimized is by Congress limiting the regulatory scope of the solvency agency. As outlined above, these costsavings could be achieved by making the agency responsible for monitoring the financial strength of insurers licensed to operate in more than one State. This has two benefits: (1) it may reduce the aggregate governmental cost of regulating multistate firms, and (2) it reduces the cost of regulatory compliance by multistate firms. In addition, retaining a State regulatory structure allows for the development of skilled regulators and allows experimentation in other areas of regulation.

A centralized agency could further address the problem of improving the quality of the financial data submitted to regulators. In 1989, the NAIC adopted standards requiring CPA audits of financial statements and an actuarial opinion on loss reserve adequacy by an actuary or other specialist. The centralized agency could require interstate insurers to comply with these proposed standards.

The solvency agency could also address the problem of regulatory delay in preventing failing insurers from accepting new business. Commentators often suggest that regulators are slow to stop troubled insurers because (1) the data used to accumulate the evidence necessary to stop the insurer is suspect, hence (2) they do not want to be liable for causing the failure of an insurer by interfering with its operation.

The primary function of the centralized agency is to improve the quality and analysis of financial information. Consequently, State regulators would have greater confidence that they would not be driving a healthy company into insolvency by obtaining an order requiring an insurer to stop accepting new business. This motivational problem will only be remedied if the agency makes it a priority to protect the interest of policyholders, and if that policy can be instilled into the solvency policing process. Only then will troubled insurers be removed as soon as possible, with a lower cost to policyholders and taxpayers.

As has been demonstrated by the analysis of insolvencies in "Failed Promises" and those regarding the savings and loan industry, giving a poorly managed company time to reverse course rarely meets with success. Consequently, additional policyholders are attracted to the failing company which further increases the losses when the company ultimately fails. The losses to policyholders that are reimbursed by the guarantee funds are then passed, in part, to policyholders of other firms who may have resisted the temptation to purchase insurance at low rates from a weak insurer. In addition, the costs are also passed on to Federal and State taxpayers. The centralized agency should be instructed by Congress to protect the interest of policyholders over the interests of owners. Through the certification process, the task force could ensure that the States also work toward that end.

Another deficiency identified in the Dingell report is the lack of prosecuting apparent criminal behavior, and the inability of the States to prevent particular individuals from exploiting insurance consumers more than once. By maintaining a data base of persons convicted of criminal activities associated with an insurer, the centralized agency could provide the States with a helpful review of individuals applying for licenses to operate insurers or reinsurers. How States use that information as part of the licensing and renewal process could be part of the State certification review. As with liquidations, the pursuance and prosecution of managers convicted of criminal behavior would be left to the various States with the centralized agency serving as a source of information and facilitator of interstate cooperation.

This proposal calls for Congress to empower a centralized agency to improve the quality of both the financial data reported and the analysis of that data. Using that type of agency has the benefit of not requiring the formation of a new Federal regulatory agency. There are models of similar types of Federal oversight in the areas of securities regulation (NASD) and aviation (CAB). Start up costs, including time, would be minimal. The various State insurance departments would be charged with enforcing the recommendations of the centralized agency for insurers domiciled in their States. The agency would promote a uniform enforcement level and Congress would be responsible for ensuring that consumer protection is given priority.

Credible solvency monitoring by a centralized agency with congressional oversight institutionalizes the threat of Federal involvement in insurance regulation. The threat of Federal legislation has previously motivated State legislatures to act in a relatively prompt and coordinated manner. It could be argued that these hearings, combined with those of the Dingell committee, in the House, will motivate an adequate regulatory response from the States. We propose that this threat of Federal involvement be ongoing. The centralized agency could be an empowered self regulatory organization, like the NASD, or it could be a task force under the auspices of the NAIC.

Adequate solvency information could also enable consumers to discipline insurer behavior. Exempting all, but the smallest, commercial insurance buyers from guaranty fund protection provides them with an incentive to use care in selecting an insurer. The savings and loan crisis has illustrated the problems associated with a lack of market discipline. Depositors protected by Federal deposit insurance were left to seek the highest rate of return at no risk of capital loss. The incentive to carefully select an insurer should not be remove from the commercial insurance market by access to guarantee fund protection.

To assure that commercial insurance buyers use care in selecting an insurer, some protection should be given to agents and brokers that inform buyers of the information produced by the centralized solvency agency. In this way the lack of guaranty fund protection can not be shifted to the agents, brokers, and their liability insurers.

The implementation of the proposed centralized agency benefits consumers of insurance and taxpayers. More effective solvency policing will reduce the number of consumers affected by insolvent insurers. Additionally, it will minimize the number of claimants against insurance proceeds that may suffer due to an insurer insolvency.

Senator BRYAN. Thank you very much. Mr. Leary, we will hear from you now.

STATEMENT OF MARTY LEARY, RESEARCH DIRECTOR, SOUTHERN FINANCE PROJECT

Mr. LEARY. Thank you for your invitation to testify. I am Marty Leary, Research Director of the Southern Finance Project, an independent, nonprofit research center based in Charlotte, NC.

The Finance Project was established in 1986 to supply policymakers, journalists, and citizen organizations with reliable information on financial markets and policies affecting the South and the Nation. Over the last year we have released a number of studies focusing on financial problems currently facing the country, from how the savings and loan cleanup affects various communities to how lender liability law effectively curtails pollution.

Although we have tackled a diverse set of issues, our research is guided by a common set of questions. Who should pay for financial calamities when they occur? How do various cleanup or bailout strategies affect average taxpayers and consumers? And what kinds of reform measures might diminish taxpayer liability and restore safety and soundness to the financial system?

These are the questions we addressed in the February 1990 report on the property and casualty insurance guaranty funds in the southern States. We studied the guaranty funds because, as you know, they really are the silent exchequers of the taxpayer and policyholder-funded bailouts that are occurring in virtually every State in the Nation.

I use the term "bailout" because over the last 20 years, the Nation's 51 property and casualty funds, and the 47 life health funds have collected over $3.8 billion from solvent insurers to pay off the claims of insolvent insurers. Nearly all of these costs are then passed along to taxpayers or to policyholders in the form of tax offsets, policyholder surcharges, or higher insurance premiums.

This point bears emphasizing. It is often asserted that well-managed, solvent insurance companies are the only losers in insurer bailouts since they must dig into their own pockets to pay the claims of their insolvent brethren. But this simply is not true. In every State but one, Illinois, property and casualty insurers are permitted to pass the cost of insolvency assessments to taxpayers and consumers. In 41 of the 47 States that have established life health funds, insurers are allowed to deduct insolvency assessments from their State taxes.

Unlike the insurance funds that protect depositors at the Nation's banks and S&L's, the State guaranty funds that back up insurance policyholders are not Government agencies. Although they were created by State statutes, very few of them are administered by insurance regulators or subject to legislative oversight. They are the only entities from which policyholders or claimants of insolvent companies can hope to recover their losses. But rarely will you find any insurance consumers represented on their boards.

In fact, in most of the States you will not even find the insurance commissioner on the board. Rather, insurance executives, typically ones representing the largest five or six companies in each State, run the guaranty boards.

Most of the property and casualty funds were created in the early 1970's following two unsuccessful attempts by members of Congress to establish a Federal guaranty fund to protect policyholders. In 1969, the National Association of Insurance Commissioners wrote a model act for State guaranty funds. With varying degrees of urgency, all the States, territories, and the District of Columbia, adopted modified versions of the act.

The life health funds, typically came a few years later and were more or less modeled after their P&C counterparts. Last year, California became the 47th State to create a life health fund. Colorado, the District of Columbia, Louisiana, and New Jersey currently do not have life health funds.

The basic idea behind the laws is that the industry should clean up after its own insolvencies without Government help. When a company fails, all the other insurers, selling similar kinds of insurance policies, are assessed a fee to cover the claims on the failed company. As long as insolvencies were small and infrequent, the system worked fairly well and State legislatures needed only make minor statutory modifications to facilitate the process of paying out claims.

Nobody seemed to mind that the costs were passed on to taxpayers or consumers since they rarely amounted to more than a tiny fraction of the total premium income of the industry. But beginning in the early 1980's, as some of the previous witnesses showed us, all that began to change.

In 1980 there were only four property and casualty insolvencies for which assessments had to be made. In 1985 there were 22. In 1980 the nationwide total of assessments reported by the 51 property and casualty funds amounted to $17.8 million. In 1985, assessments totalled over $336 million. Property and casualty assessments continued to rise in 1986 and 1987, dropping only briefly in 1988 before climbing to a record $774 million in 1989.

The life health fund assessments rose even more rapidly during this period, from just under $4 million in 1980 to $164 million in 1989. In 1989, there were 43 life health company failures compared to 5 in 1980.

The sudden surge in insurance company insolvencies severely strained the fragile guaranty fund system and revealed some serious shortcomings in the State-by-State system of solvency regulation. Fund managers contacted during our study of the southern property and casualty funds were quick to point out that policyholders and claimants of failed companies were almost always paid in a timely manner. But they mentioned a host of problems that made it increasingly difficult to protect policyholders.

Some of the problems they mentioned were inadequate solvency legislation, a reluctance on the part of many regulators to enforce existing state solvency laws or to shut down insolvent companies, lack of legislative oversight of the insurance departments or the guaranty funds, lack of clear lines of authority and accountability among regulators, liquidators, and guaranty fund administrators, lack of effective regulation of reinsurance companies, lack of communication among States, excessive secrecy on the part of regulators and guaranty fund officials, and fraud.

Recently, the National Association of Insurance Commissioners has made significant progress in addressing many of these problems. But the larger economic forces underlying the rapid rise in insurance company's insolvencies—high interest rates, new interest-rate-sensitive insurance products, and the general deterioration in the quality of the industry's asset base—cannot be reversed or even contained simply by tinkering with NAIC model acts.

Meanwhile, the insolvency costs are skyrocketing and taxpayers and policyholders have been left holding the bag. How much do they stand to lose? Unfortunately, they may lose quite a lot if the present system is not reformed.

The Southern Finance Project recently analyzed assessment data for the 51 property and casualty funds and the 44 life health funds that had made assessments prior to 1990. The full results of that study will be released in a report next month.

Based on our preliminary analysis, we believe the dramatic increase in insurance company insolvencies may overwhelm the piecemeal guaranty fund system, burdening taxpayers, consumers, and policymakers for years to come.

Specifically, we found that if the funds continue to levy assessments at their current triennial rates, taxpayers and policyholders will be saddled with an additional $13.7 billion in property and casualty assessments and $3 to $7 billion in life health assessments. That is by yearend 1992. If any one of the nation's large life and health companies were to fail, these loses could double.

Further, we found that the losses may be concentrated in just a handful of States, some of which are already struggling under the stain of severe budget crunches.

I will not go into as much detail on some of the other findings, as I did in the written testimony, which you may want to submit for the record at this time.

Senator BRYAN. The entire statement will be submitted. Why do you not highlight those points that you think we need to have for the benefit of any action that you are recommending?

Mr. LEARY. What we found in a nutshell is that the rate of increase in assessments for the life and property-casualty funds was really astronomical.

Just an example: between 1984 and 1986, property and casualty assessments soared by 442 percent over the inflation- adjusted amount of the previous 3 years. The next 3 years—1987 to 1989—the assessments increased by an additional 89 percent, and there were seven States in our survey where life-health guaranty assessments rose by more than 1,000 percent. Of course, in the early days of these funds the assessments were almost negligible. Nevertheless we feel this is a very serious rise in assessment rates.

Jumping to some of our reform proposals. They are outlined rather generally in the written testimony. The most important one is that taxpayers and policyholders should not bear the burden of guaranty fund assessments. We think the tax offset provisions, policyholder surcharges and recoverability via ratesetting should be abolished altogether.

The assessment should be financed from the profits of the industry and should be considered a normal cost of doing business. If regulators need to make a special assessment exemption for companies that are marginally solvent, then of course they should be allowed to do so.

We also believe that real safety and soundness requires that guaranty associations be prefunded—most of them now are not—and staffed with qualified, full-time employees. Language can easily be inserted into the statutes to assure that the funds will not be used for purposes other than paying out claims or operating the associations.

Third, we believe that risk-based premiums should be established to provide incentives for prudent management. This could work in a number of ways. One way would be for the insurers to be assigned risk grades to determine their assessment rates. Companies that are deemed by regulators to be riskier would pay at a higher rate.

We also believe that guaranty associations should be public bodies and subject to open meeting laws and other sunshine provisions. The boards of the guaranty associations should contain a majority of public representatives. Finally, we believe the guaranty fund reforms should not occur in a vacuum. They must be backed up by stricter investment controls, better accounting procedures, higher capital and surplus requirements, and regulation and monitoring of reinsurance agreements.

Thank you.

[The prepared statement of Mr. Leary follows:]

PREPARED STATEMENT OF MARTY LEARY

Mr. Chairman, members of the committee, thank you for your invitation to testify. I am Marty Leary, research director of the Southern Finance Project, an independent, nonprofit research center based in Charlotte, NC. The Finance Project was established in 1986 to supply policymakers, journalists, and citizen organizations with reliable information on financial markets and policies affecting the South and Nation.

Over the last year, we have released a number of studies focusing on financial problems currently facing the country, from how the savings and loan cleanup affects various communities to how current lender liability law effectively curtails pollution.

Although we have tackled a diverse set of issues, our research is guided by a common set of questions: Who should pay for financial calamities when they occur? How do various cleanup or bailout strategies affect average taxpayers and consumers? And what kinds of reform measures might diminish taxpayer liability and restore safety and soundness to the financial system?

These are the questions we addressed in a February 1990 report on property & casualty insurance guaranty funds in the southern States. We studied the guaranty funds because they are the silent exchequers of the taxpayer and policyholder-funded bailouts that are occurring in virtually every State in the Nation.

I use the term "bailout" because over the last twenty years, the Nation's 51 property & casualty funds and 47 life/health funds have collected over $3.8 billion from solvent insurers to pay off the claims of insolvent insurers. Nearly all of these costs are then passed along to taxpayers or to policyholders in the form of tax offsets, policyholder surcharges, or higher insurance premiums.

This point bears emphasizing. It is often asserted that well managed, solvent insurance companies are the only losers in insurer bailouts since they must dig into their own pockets to pay the claims of their insolvent brethren. But this simply isn't true. In every State but one—Illinois—property and casualty insurers are permitted to pass the cost of insolvency assessments to taxpayers and consumers. And 41 of the 47 States that have established life/health funds allow insurers to deduct insolvency assessments from their State taxes.

Unlike the insurance funds that protect depositors at the Nation's banks and S and L's, the State guaranty funds that back up insurance policyholders are not government agencies. Although they were created by State statutes, very few of them are administered by insurance regulators or subject to legislative oversight. They are the only entities from which policyholders or claimants of insolvent companies can hope to recover their losses, but rarely will you find any insurance consumers represented on their boards. In fact, in most of the States, you won't even find the insurance commissioner on the board. Rather, insurance executives—typically ones representing the largest five or six companies in each State—run the guaranty boards.

Most of the property and casualty funds were created in the early 1970s, following two unsuccessful attempts by members of Congress to establish a federal guaranty fund to protect policyholders. In 1969, the National Association of Insurance Commissioners wrote a model act for State guaranty funds. With varying degrees of urgency, all the States, territories, and the District of Columbia adopted modified versions of the act. The Life/health funds typically came a few years later and were more or less modeled after their P and C counterparts. Last year, California became the 47th State to create a life/health fund. Colorado, the District of Columbia, Louisiana, and New Jersey currently do not have life/health funds.

The basic idea behind the laws is that the industry should clean up after its own insolvencies, without government help. When a company fails, all the other insurers selling similar kinds of insurance policies are assessed a fee to cover the claims on the failed company.

As long as insolvencies were small and infrequent the system worked fairly well and State legislatures needed only make minor statutory modifications to facilitate the process of paying out claims. Nobody seemed to mind that the costs were passed on to taxpayers or consumers since they rarely amounted to more than a tiny fraction of the total premium income of the industry.

But beginning in the early 1980's, all that began to change. In 1980, there were only four property and casualty insolvencies for which assessments had to be made. In 1985 there were 22. In 1980, the nationwide total of assessments reported by the 51 property and casualty funds amounted to $17.8 million. In 1985, assessments total led over $336 million. P&C assessments continued to rise in 1986 and 1987, dropping briefly in 1988 before climbing to a record $774 million in 1989.

Life/health fund assessments rose even more rapidly during this period—from just under $4 million in 1980 to $164 million in 1989. In 1989 there were 43 life/health company failures compared to 5 in 1980.

The sudden surge in insurance company insolvencies severely strained the fragile guaranty fund system and revealed some serious shortcomings in the State-by-State system of solvency regulation. Fund managers contacted during our study of the southern property and casualty funds were quick to point out that policyholders and claimants of failed companies were almost always paid in a timely manner. But they cited a host of problems that made it increasingly difficult to protect policyholders. Some of the problems they mentioned were:

- inadequate solvency legislation;
- a reluctance on the part of many regulators to enforce existing State solvency laws or to shut down insolvent companies;
- lack of legislative oversight of the insurance departments or the guaranty funds;
- lack of clear lines of authority and accountability among regulators, liquidators, and guaranty fund 'administrators;
- lack of effective regulation of reinsurance companies;
- lack of communication among States;
- excessive secrecy on the part of regulators and guaranty fund officials;
- fraud.

Recently, the National Association of Insurance Commissioners has made significant progress in addressing many of these problems. But the larger economic forces underlying the rapid rise in insurance company insolvencies—high interest rates, new interest rate-sensitive insurance products, and deterioration in the quality of the industry's asset base—cannot be reversed or even contained simply by tinkering with NAIC model acts. Meanwhile, insolvency costs are skyrocketing and taxpayers and policyholders have been left holding the bag.

How much do they stand to lose?

Unfortunately, they may lose quite a lot if the present system is not reformed. The Southern Finance Project recently analyzed assessment data for the 51 property and casualty funds and the 44 life/health funds that made assessments prior to 1990. The full results of that study will be released in a report next month.

Based on our analysis, we believe the dramatic increase in insurance company insolvencies may overwhelm the piecemeal guaranty fund system, burdening taxpayers, consumers, and policymakers for years to come. Specifically, we found that:

- If the funds continue to levy assessments at their current triennial rates, taxpayers and policyholders will be saddled with an additional $13.7 billion in property and casualty assessments and $3 to $7 billion in life/health assessments by 1992. If any one of the Nation's large multiline companies were to fail, these losses could double.
- The losses may be concentrated in a handful of States, some of which are already struggling under the strain of severe budget crunches.

We reached these conclusions after thoroughly examining actual assessment data for the 95 guaranty funds included in our study. The data revealed that:

- Although most of the property and casualty funds came into existence during the early 1970's, more than three-quarters of the nationwide total of property and casualty assessments occurred after 1984.
- Fifty-nine percent of the nationwide total of assessments made by the 42 life/health funds in our study were levied after 1986. Assessments in 1989 alone accounted for twenty-eight percent of the constant dollar volume of assessments between 1975 and 1989.
- Prior to 1984, property and casualty assessments rose at a steady but modest rate. But between 1984 and 1986, P&C assessments soared by 442 percent over the inflation adjusted amount of the previous 3 years. Between 1987 and 1989, P&C assessments increased by an additional 89 percent.
- Between 1987 and 1989, life/health guaranty assessments rose by more than 1,000 percent in seven States. Those States were Montana, Washington, Nebraska, Wisconsin, Minnesota, Kentucky, and North Carolina.
- A significant factor in the overall rise in life/health guaranty fund assessments was the astronomical rise in payouts to holders of annuity contracts written by insolvent insurers. Between 1987 and 1989, nationwide assessments for annuities rose by 1,893 percent compared to the inflation adjusted amount of the previous three years assessments. Life assessments increased at a rate of 682 percent, and health assessments rose by 174 percent.
- Over the past two decades, nearly two-thirds of the nationwide total of property and casualty fund assessments occurred in seven populous States—California, Florida, Texas, Illinois, Pennsylvania, Michigan, and Minnesota. Two of these States—Texas and California—were among the eight States where P&C assessments more than quadrupled between 1987 and 1989.
- Between 1975 and 1989, two-thirds of the nationwide total of life/health assessments were concentrated in seven States—Texas, Florida, Illinois, Washington, Arizona, Indiana, and Oklahoma. Assessments in Texas alone accounted for twenty eight percent of the nationwide total.

If these trends continue, taxpayer and ratepayer liability will reach at least $20 billion by 1992. Compared to the $500 billion S&L pricetag that may not seem like a lot. But as late as 1986, you may recall, the Federal Home Loan Bank Board had concluded that the S&L problem could have been cleaned up for about $20 billion.

I do not mean to suggest that the insurance solvency crisis will rival the S&L blowout in sheer dollar terms. Nevertheless, there are some eerie similarities.

To begin with, many of the economic forces that set thrifts on their giddy path toward self-destruction also took a toll on insurers. Financial market volatility, inflation, and the Federal Reserve's decision to sustain record-high real interest rates permanently altered the environments in which financial institutions operated.

In the early 1980's, both S&L's and insurers faced new competition from unregulated financial firms such as brokerage houses, which offered high-yield money market accounts to sophisticated savers. S&L's, through their ubiquitous lobby, the U.S. League of Savings Institutions, responded to this challenge by clamoring for the lifting of interest rate ceilings, new investment powers and regulatory forbearances. Congress, State legislatures, and Federal regulators obliged.

The life/health insurers didn't need to ask for regulatory forbearance. In most cases, they already had it. To lure funds back from their competitors they invented a host of complicated insurance products, many of which proved to be hyper-sensitive to changes in interest rates.

Just as newly deregulated S&L's became addicted to the "hot money" provided by Wall Street money brokers in the 1980's, underregulated life insurers gorged themselves with fast cash generated from the sale of annuities and guaranteed investment contracts. In 1978, life companies derived about one fifth of their premium income from such annuities. In 1988, annuity income accounted for almost half (47 percent) of the premium pie.

S&L's plowed much of their federally insured "hot money" into junk bonds and speculative commercial properties. High flying insurance companies did exactly the same thing with their taxpayer- and ratepayer-backed premium income.

According to Drexel Burnham Lambert, which was in a position to know such things, life/health insurance companies held approximately 30 percent of the junk bonds that existed at yearend 1988.

More recently, the research firm Townsend and Schupp reported that the hundred largest life insurers, representing 71 percent of the industry's asset base, held "high risk assets" amounting to 91 percent of their combined statutory surplus and mandatory securities valuation reserve. High risk assets included noninvestment grade bonds, overdue mortgages and foreclosed real estate.

Using data prepared by the American Council of Life Insurers, James O'Leary, an economic consultant to the U.S. Trust Company, determined that the Nation's largest life insurers held more than $12 billion in nonperforming commercial loans as of September 1990. The $12 billion represented approximately 5.9 percent of their combined commercial mortgage portfolio.

In our forthcoming report, we examine in more detail the serious erosion of asset quality at the Nation's largest life/health insurers. The report also scrutinizes the balance sheets of the largest failed life/health insurers in order to document how their investment choices affected their financial condition.

Regulation currently places greater restrictions on the investment choices of property and casualty insurers than on their more adventuresome cousins in the life/health industry. Nevertheless, increasing numbers of P&C companies are finding their own ways into the red.

The most common method is cash-flow underwriting, or the deliberate underpricing of insurance policies in order to generate fast cash. Practitioners of cash-flow underwriting substitute quality for quantity and sacrifice prudent underwriting standards on the bet that interest rates will rise faster than liabilities will mount. It is a bet that most companies lose.

Insurance industry spokesmen often complain that it is unfair to compare their problems with the S&L fiasco. To their credit, many insurance industry leaders and trade associations have demonstrated a sincere desire to reform their industry and restore it to financial health and probity.

Unlike the S&L industry, insurers do not seem to be going out of their way to fool themselves or the public about the true seriousness of their problems. They are not dodging the tough questions that have been raised in Congressional hearings such as this one.

However, there is one tough question—rarely raised in Washington—that forms the most disturbing parallel between the thrift crisis and today's insurance industry problems. Who should pay for financial industry meltdowns? Those who caused and benefited from them, or those who were left holding the bag by an inadequate regulatory system?

Had that question been put before the American people during the first S&L industry bailout in 1986, the answer undoubtedly would have been "the industry should bail itself out." And given the comparatively small pricetag the industry probably could have done so at that time. Everyone now knows the ugly and expensive consequences of failing to confront the S&L problem in a prompt and straight forward manner.

Let's heed this fundamental lesson from the S&L fiasco: The insurance industry should for its own bailout while it still can.

There is no law of economics that says financial disasters have to proceed uninterrupted until the costs rise to such levels that only taxpayers can pick up the tab. Insurance companies are private, profit-maximizing institutions. But they are—or should be—more. They provide services that are absolutely vital to millions of citizens, corporations, and small businesses.

To ensure that the insurance industry remained profitable and viable, policymakers over the years afforded it many special protections, including the 1945 McCarran-Ferguson Act which exempted insurers from Federal anti-trust provisions.

In effect, Congress said to the insurance industry "we want you to stick around for a while, so we re going to guarantee your ability to get the prices you need for your products." That was the implicit social contract embodied in McCarran-Ferguson.

But as more and more companies fail, saddling citizens with larger and larger cleanup bills, the old social contract is eroding and a new one is taking shape. Guaranty fund reform must be an essential part of the new social contract between the public and its insurance industry.The easiest way to reform the system would be to scrap the precarious State-by-State guaranty fund system altogether and establish a National fund under the oversight of a Federal agency. But States shouldn't wait for the Federal government to protect taxpayers and policyholders. Whether guaranty fund reform occurs at the State or Federal level, we believe it ought to include the following elements:

- Taxpayers and policyholders should not bear the burden of guaranty fund assessments.Tax offset provisions, policyholder surcharges, and recoverability via rate-setting should be abolished. Assessments should be financed from the profits of the industry and should be considered a normal cost of doing business. If regulators need to make special assessment exemptions for companies that are marginally solvent, they should of course be allowed to do so.
- Real safety and soundness requires that guaranty associations be pre-funded and staffed by qualified full time employees. Language can easily be inserted into the statute(s) to ensure that the funds will not be used for purposes other than paying-out claims or operating the associations.
- Risked-based premiums should be established to provide incentives for prudent management. Insurers can be assigned risk grades that determine their assessment rates. Companies deemed by regulators to be risky would pay at higher rates. The risk grades should be assigned using an explicit formula or series of formulas that measure such factors as asset quality, product mix, capital and surplus ratios and rate of premium growth. Risked-based premiums provide proper incentives only if companies are prohibited from passing-on the costs of assessments to taxpayers or policyholders.
- The guaranty associations should be public bodies subject to open meetings laws and other "sunshine" provisions. The boards of guaranty associations should contain a majority of public representatives.
- Guaranty fund reforms should not occur in a vacuum. They must be backed-up by stricter investment controls, better accounting procedures, higher capital and surplus requirements and regulation and monitoring of reinsurance agreements.

That concludes my formal testimony. I would be happy to answer any questions you may have.

Senator BRYAN. Thank you very much, Mr. Leary. Mr. McCartney, we will hear from you now.

STATEMENT OF WILLIAM H. McCARTNEY, VICE PRESIDENT OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. MCCARTNEY. My name is Bill McCartney. I am vice president of the National Association of Insurance Commissioners and Director of Insurance for the State of Nebraska.

The NAIC is an association of the chief insurance regulators from the 50 States, the District of Columbia, and 4 U.S. territories. We thank you for this opportunity to discuss the important topic of the regulation of insurance companies for solvency.

Certainly, one of the lessons of the 1980's is that no regulatory system, State or Federal, is perfect. The rapidly changing environment of financial services products has created new challenges for regulators at all levels, in all sectors of the financial industry.

There is another lesson of the last decade, and that is that the notion that Federal regulation is inherently superior to State regulation is groundless. It is no coincidence that the State-regulated insurance industry has weathered the economic storms of the last decade in better shape than other sectors of the financial services industry.

State insurance regulators have a long history of prudent regulation which has served the American consumer quite well. There is no question that the insurance solvency regulation can be improved. I am convinced, however, that the best way to improve this system is to build upon the strengths at the State level.

While we welcome the attention paid to us by the Congress, we urge caution upon the Members of this body as you look for ways to assure your constituents that their insurance companies will fulfill the promises they have made. The system that has served insurance consumers for over a century is functioning well, and rapidly getting better.

The 120-year history of the NAIC is one of innovation and adaptation in the regulation of an industry which has undergone dramatic changes in the past century. My written testimony describes in greater detail some examples of that innovation.

In the current environment in which the troubles in federally regulated financial institutions have shaken consumer confidence in all financial institutions, the NAIC moved quickly to address regulatory concerns. Beginning in 1988, we developed minimum financial regulation standards for the individual State insurance departments. These standards, which were finally adopted by the NAIC in 1989, established bottom-line requirements for State solvency regulation in three key areas: laws and regulations, regulatory practices and procedures, and organizational and personnel practices.

In order to provide guidance to the States regarding the minimum standards and an incentive to put them in place, the NAIC adopted a formal certification program in June 1990. Under this certification program, each State's laws and the operation of its insurance department will be reviewed by an independent review team whose job it is to assess compliance with the NAIC's financial regulation standards.

Beginning in January 1994, accredited States will not accept reports of insurance company examination from nonaccredited States, providing further impetus for States to adopt the minimum standards. As a result, being domiciled in a nonaccredited State will increasingly become a liability for insurance companies, inducing States to meet the standards or witness the exit of those companies from their States.

In 1990, two States were accredited and we expect a number of other States will be accredited this year. Our program has received the full support of the National Conference of State Legislatures, the National Governors Association, and the National Conference of Insurance Legislators. In response, legislatures across the Nation, including Nebraska, are moving aggressively toward the implementation of legislation called for by the NAIC standards. While we will not know the full success achieved in this cycle of legislative sessions until later this year, I am confident that 1991 will be marked by the most sweeping enactment of insurance solvency legislation in the history of this country.

But the adoption of the financial regulation standards is only one aspect of a broader solvency policing agenda of the NAIC, which was first adopted in December 1989 and updated last December. Let me outline some of the items, the key important parts of this solvency policing agenda.

First, regulation of reinsurance activity is of particular importance to State regulators. In order for insurance consumers to be confident that their insurance company can make good on its promises to them, they must be confident that the insurer's reinsurer is willing and able to keep its promises.

We have taken a number of important steps in this area. We have enhanced the method of regulating foreign reinsurance companies through the balance sheet of the primary carrier by adopting a new, detailed reporting requirement which gives primary carriers a financial incentive to ensure that their reinsurance companies pay promptly.

Second, we have established a more refined computerized reinsurance database which will allow regulators to track the reinsurance operations of all companies in the United States, including reinsurance ceded to virtually any company worldwide.

Third, we have adopted a reinsurance intermediary, a model act, which mandates licensing for brokers and managers of reinsurance and establishes minimum requirements for the relationship between ceding insurers, intermediaries, and reinsurers.

Fourth, we adopted a management general agents act which is designed to weed out the improprieties that led to the abuse of the MGA function in some of the more conspicuous insolvencies in recent times.

Finally, we recently appointed a working group to analyze and recommend ways to improve the regulation of not only alien reinsurers but alien insurers as well.

Another key component of the solvency policing agenda for 1990 was an overall assessment of the examination process—the way we examine insurance companies. Last December, the NAIC adopted a model law on examinations, and the NAIC adopted a requirement that insurance company financial statements be audited annually by a certified public accountant.

We also require that actuarial opinions regarding the adequacy of a property-casualty insurers reserves comment specifically upon items which might materially affect reserves, and we now require that actuarial opinions address both gross and net reserves, a modification that will give regulators a clearer picture of a company's total potential liability if reinsurance agreements were to fail.

This year, we are also looking at a system of risk-based capital requirements for insurance companies, and we anticipate that the NAIC will take action on risk-based capital requirements for insurance companies later this year. We are also considering, and probably will adopt, a new model investment in medium-grade and lower grade obligations act, which will regulate insurance company investments in noninvestment-grade securities.

But while we are doing that—those are things that took place in 1990—we have an additional, very ambitious, solvency-policing agenda for 1991. We continue to build on the steps that were taken in 1988, 1989, and 1990, the gist of which is that the State regulatory system has not been sitting on its hands. Many of the comments and the criticisms you heard today came out of events that took place 3, 4, 5 years ago. The NAIC has also been cognizant of those events and has been taking material steps to enhance the State regulation of the insurance industry in this country.

Senator BRYAN. Mr. McCartney, thank you very much for your testimony. Let me begin with you with just a couple of questions, and that is, you heard Mr. Leary's testimony, and the focus of the reform that he is suggesting to us deals with the way these guaranty funds are organized and the practice that in effect allows insurance companies to lay off on policyholders and ultimately the taxpayers credits on tax liabilities that are due.

He asked that these associations include more public members, that the insurance commissioners in some States, who are not part of these associations, ought to be more active, and that these ought to be much more open than they have in the past.

What is your reaction to that, and what has NAIC done, if anything?

Mr. McCARTNEY. In every one of those States where there is a guaranty fund, the guaranty fund board operates under a specific statutory scheme, so it is not a case where these people are out there doing whatever they want to do without any kind of direction from the State.

That is not the case. There are statutes that govern their actions, and in Nebraska I am involved in both of the guaranty funds that take place—that operate in our State. I do not serve on the board, but we generally have a representative of the department attend all board meetings.

At the same time, we recognize that there could be some enhancements that could be made to the guaranty fund system. We are in the process of appointing a blue ribbon panel of commissioners as part of the solvency policing agenda from 1990 to look at all of these aspects relating to guaranty funds, and not only the way guaranty funds operate and are set up, but also their relationship with rehabilitation and liquidation of insurance companies. That effort will be chaired by acting director Jim Shod of Illinois.

Senator BRYAN. And you will keep the committee apprised of the comment that you make on that? Do you agree in general with some of the observations he makes?

Essentially Mr. Leary is saying that historically in most States these have been by and large viewed as somewhat private functions. That is they primarily consist of private members from the insurance industry.

They may be operating under statutory framework, but essentially they have not been a public body in the sense that there are members of the general public who serve and that, indeed, insurance commissioners themselves are obligated or required even to have a representative on the board.

Mr. McCARTNEY. It is true in Nebraska. I can only speak for Nebraska. It is true that the membership of the boards of our guaranty funds consist of insurance industry people. But at the same time, many of the issues that are addressed by the guaranty funds, collection, payment of claims, and collection of assessments from insurance companies involve fairly detailed and technical issues. And it is necessary to have some expertise in the area in order to be able to perform that function.

Senator BRYAN. Mr. McCartney, you were here I think and heard the testimony by Mr. Jack Snyder, I think it is, from A.M. Best. He had a recommendation of about four or five things that he thought could be done to improve the quality of regulation dealing with more stringent financial examination, more timely gathering of data, stiffer fines, and penalties. Have you had a chance to take a look at that? That may be included in some of the things that you were testifying to in terms of your own association review.

Mr. McCARTNEY. All of those are items that the NAIC has either put in place or are looking at. For example, we require quarterly financial statements for the most part from insurance companies, so timely and complete information from the insurance industry, of course, is a concern. But we have taken a number of steps to put those things in place.

Senator BRYAN. So, philosophically you would not differ generally from some of the recommendations and the approach suggested by that testimony.

Mr. McCARTNEY. Philosophically, no. Perhaps, with some of the specifics.

Senator BRYAN. Now Mr. Barrese and Dr. Nelson, you heard them. They talked about establishing some type of a central solvency surveillance under the aegis of Federal legislation, not necessarily a Federal agency, but I believe Dr. Nelson used the analogy of the NASD as I recall.

Does that have any merit in your view?

Mr. McCARTNEY. Well, I do not mean to be flippant, Mr. Chairman, but in my tenure as insurance commissioner, except for the term, actuarial science, I think self-regulatory organization is the biggest oxymoron that I have heard.

I do not see how the insurance industry, this group of companies, can get together and say your rates are too low, you need to increase your rates to other members of the industry or we do not like some of your assets and unless you change your asset portfolio, we are not going to let you write any more.

That is a job for regulators. That is not a job for one company in the industry to be telling to other companies in the industry.

Senator BRYAN. In fairness, and Dr. Nelson may care to comment, I did not understand or gather from his testimony that this central solvency concept that he and Mr. Barrese were advancing was to supersede the State regulatory determinations as to rate structures, but to establish financial standards.

Dr. Nelson, tell me if I have misunderstood your suggestion?

Dr. NELSON. Yes. The idea was to establish some centralized and consistent standards across the Nation and to produce information available to people like Mr. McCartney as commissioners. And they would then be able to act on that information.

Senator BRYAN. Your reaction to that? Do you think it has any merit at all, the centralized solvency standard concept that there be some uniformity at least in terms of financial standards?

Mr. McCARTNEY. Absolutely I do. And that is exactly the program that the NAIC began in 1988 when it adopted this financial regulations standards program. There are, I think, 23 model laws or laws and regulations that are required to be in place. There are practices and personnel policies that have to be in place in the departments.

Those standards have already been developed by the NAIC. We need a couple of years to bring all the States in compliance with those. But we have identified the areas that we think are important.

Senator BRYAN. Mr. McCartney, I have been impressed with a number of things. As you know I had occasion to meet with your association earlier this year and I think that you have done a number of things that move in the right direction.

I suppose your critics might say that is all well and good and we agree and we think NAIC is on the right track, but essentially it is a voluntary organization. Your promulgation of standards, your promulgation of timely review, all of the kinds of things that do, in fact, seem to address some of the concerns that were raised, do not, in and of themselves, translate into action because it requires the respective States to either by regulation, or probably in most instances, by statute to actually implement those.

What would your response be to those critics that say you are on the right track, it sounds great, but there is no assurance that that is going to be done at the State level?

Mr. MCCARTNEY. We had a meeting here yesterday, Senator, at which regulators from 23 different States attended. And except for three of those States, I think the commissioners were present.

One of the questions I asked at that meeting was tell me about your legislative packages for the year. And New York and Florida were there so they can be exempted, they have been a credit. I said how many of you, as part of your legislative packages for the year, have compliance with the financial regulations standards as a cornerstone. And everybody in the room raised their hand.

I am convinced that we are going to see this year more financial solvency enactments put in place in the States than ever before in this history of this country. The program is in place. It has the support of legislators, Governors, regulators. We need 1 or 2 years to get it there.

It is not quite accurate to say it is voluntary. It is sort of voluntary at this point, but once we get a majority of the States certified, if you are a domestic company, domiciled in a State that is not certified, we are in the process of preparing sanctions right now. One of those sanctions has been mentioned here.

I think we are going to get to the point where we say, if you are from a nonaccredited State, you are not going to be able to do business in the accredited States. That is a heck of an incentive, financial and otherwise, for the insurance industry and the policymakers in those States to get behind this program.

Senator BRYAN. I am encouraged to hear that. As you have gathered from the testimony of each of the panels with the exception of a proposal for central solvency, which may have some Federal implication, Mr. Leary's suggestion with respect to the treatment of the guaranty fund organization, I think it is fair to say that the record this morning reflects no clarion call for Federal action.

But as I shared with your members that if these problems continue to persist, if indeed the States fail to take action, the political process, like nature, abhors a vacuum and there will be action taken at the Federal level.

I would hope that you all would carry on with what you are doing and to implement those reforms and to make us aware, at the Federal level, of what you are doing. I appreciate that.

Mr. MCCARTNEY. Mr. Chairman, let me just say, I appreciate your comments and I can tell you that the regulators are hearing loudly and clearly the message that is coming from the Senate and the Congress on these very issues.

[The information supplied by the National Association of Insurance Commissioners is being retained in the committee's files.]

Senator **Bryan**. Gentlemen, I would like to thank each of you, Mr. Barrese, Dr. Nelson, Mr. Leary, Mr. McCartney for your testimony, for your patience. We appreciate your comments.

We are going to leave the record open for any further questions that other committee members might have.

This committee hearing stands adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

FAILURE OF THE EXECUTIVE LIFE INSURANCE CO.

TUESDAY, MAY 7, 1991

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., room SR-253, Russell Senate Office Building, Hon. Richard H. Bryan, presiding.

Staff members assigned to this hearing: Moses Boyd and Linda Lance, professional staff members; and Alan Maness and Sherman Joyce, minority professional staff members.

OPENING STATEMENT BY SENATOR BRYAN

Senator BRYAN. Good morning, ladies and gentlemen. Welcome to the hearing of the Senate Commerce Committee, which has jurisdiction over insurance industry legislation at the national level.

The Consumer Subcommittee announced earlier this year a series of hearings to look at the financial condition of the insurance industry. Our agenda included examining the regulatory controls over the industry which is primary regulated at the State level, to see if the system protects the consumer.

On February 27 of this year we held our first hearing where we looked at the issue of insurance industry's insolvency in general. Today, and again on Thursday, we are focused on what has become the largest takeover in the history of the life insurance industry: the seizure by the State of California on April 11 of this year and the State of New York on April 16 of Executive Life.

The picture is not a pretty one. There was a total breakdown of the regulatory system. Early warning signals either did not work or did not exist. At the time of its seizure, Executive Life of California had 170,000 life insurance policies in force, 75,000 annuities, and several thousand guaranteed investment contracts.

Together, policy values exceeded $45 billion. Executive Life of New York had an additional 3 billion dollars' worth of policies and contracts.

Executive Life's 300,000 policyholders live in all 50 States and the District of Columbia. Let me emphasize that the failure of Executive Life is a national problem and not just a problem for California or New York, and that the consequences of this failure will be felt in all States.

In my own State of Nevada there appear to be more than 2,300 Executive Life policies in force, with a total face value in excess of $400 million.

Thousands and thousands of policyholders were counting on Executive Life to send them a monthly pension check and retirement or to provide the funds for their survivors in the event of their death.

These policyholders invested their hard-earned money in Executive Life. Executive Life in turn took their money and invested it in junk bonds.

During the 1980's Executive Life and its parent company, First Executive, led by its chairman, Fred Carr, took the high-risk route of junk bond investments, motivated by greed, the chairman and officers of Executive Life wanted to make a lot of money and make it fast.

And make money they did. From 1980 to 1989 the company's assets grew from approximately $800 million to more than $19 billion. By the end of 1990, Executive Life of California had 67 percent of its assets in junk bonds.

However, in the late 1980's, the junk bond market began its freefall. Executive Life sustained a loss of $856 million in the investment year 1989 and a loss of $541 million in the following year.

As the junk bond market unraveled, Executive Life was still selling policies to unsuspecting consumers, using top ratings from insurance rating companies and apparently healthy audit reports from well-known auditing firms.

For nearly a century, insurance rating services have evaluated the financial strength of insurance companies. Conservative insurance customers typically look to the rating agencies for guidance, and insurance companies, like Executive Life, use these ratings to market their products.

Two leading rating services evaluated Executive Life, A.M. Best and Standard & Poors. A.M. Best's top rating is an A-plus and is described by the firm as being given to insurers who, and I quote, "generally have demonstrated the strongest ability to meet their respective policyholder and other contractual obligations."

Standard & Poors Corp. uses a triple A rating as its top mark, and in its own words describe those who receive the triple A as having, and again I quote, "extremely strong capacity to meet contractual policy obligations. Insurers rated triple A offer superior financial security."

Until January 1990, both A.M. Best and Standard & Poors continued to give Executive Life their top ratings. These top ratings were also used by Executive Life as part of its marketing strategy.

In one of their brochures, issued in December 1989, in which they described their deferred annuity, the Executive annuity summary presented by Executive Life goes on to describe the security available to those who purpose this particular policy, and I am quoting: "The safety of your money is assured. Your annuity is guaranteed by a contract and protected by the financial strength of Executive Life Insurance Co., with assets of over $10 billion and insurance in force of over $50 million. Executive Life Co. is rated A-plus—superior, by A.M. Best Co., insurance analysts since 1899. A.M. Best's highest rating has been awarded to Executive Life continuously since 1978, A-plus—superior, indicates the company's relative strength in the insurance industry and reflects its operating performance and financial strength. In addition, Standard & Poors has granted Executive Life its highest claims paying ability rating, triple A."

On a similar note, Deloit & Touche, one of the Nation's largest accounting firms, performed annual audits on Executive Life for a number of years. Its audit report dated March 29, 1990, says nothing to alert the consumer to the severe financial problems already pushing Executive Life toward insolvency.

Less than a year later, a new auditor, Price Waterhouse said in its March 27, 1991, report that there is, and I quote, "Substantial doubt about the company's ability to continue as a going concern." Two weeks later, the State of California seized Executive Life, followed 5 days later by a similar seizure by the State of New York.

Serious ethical concerns are raised about the work performed by Deloit & Touche firm. As pointed out recently by the Los Angeles Times, William Sanders, the Deloit auditor who worked on the Executive Life audits, left the Deloit firm in May 1990, 2 months after issuing Executive Life a clean audit, to join Executive Life at a salary of $300,000, plus other compensation.

Mr. Sanders took with him at the time he left seven other Deloit accountants, including three who helped completed the most recent Deloit audit of Executive Life.

This is a fact pattern which invites comparison with the Arthur Young accountant who took a $900,000 job with Mr. Keating of Lincoln Savings and Loan shortly after giving Mr. Keating's firm a clean bill of health.

Today Executive Life of California and Executive Life of New York are in conservatorship. The much larger Executive Life of California is operating under court order which permits annuitants to receive some 70 percent of their benefits.

If your money is part of an Executive Life's $3 billion in investment contracts, your funds are in limbo with no guaranteed payment. Meanwhile, a buyer is being sought for the Executive Life companies.

As a further complication, the Internal Revenue Service has stepped in with the claim of $643 million for unpaid taxes in the years 1981 through 1983, with the question still remaining, on what claims if any may be filed for later years.

If a buyer is not found and Executive Life is determined to be insolvent, the responsibility to the policyholders shifts to the States where policyholders reside. Forty-seven States have State guarantee fund associations which can impose assessments on all life insurance companies doing business in the State to bail out the failed company.

However, there are serious consequences if insolvency occurs and the States must step in. Policyholders are extremely unlikely to recover the full value of their coverage. Healthy insurance companies, forced to pay into the guarantee funds will pass increased premium costs along to all insurance consumers.

Already right State budgets will be adversely impacted by the loss of tax revenues, due to the assessed company's ability in some States to offset their tax liabilities by the assessments they have paid, and the specter of a bailout at the State or Federal level will become a distinct possibility.

No one has suggested nor can we conclude that the entire life insurance industry is in trouble when it clearly is not, but there are problems beyond Executive Life.

Yesterday's Wall Street Journal article on First Capital raises serious questions on yet another major insurance firm with large junk bond holdings.

How did the Executive Life failure occur? Where were the regulators? What is wrong with the rating system which continued to give high marks to a failing company? What ethical checks are needed on auditing firms, and what action did the National Association of Insurance Commissioners take?

In December 1990, just 4 months before Executive Life failed, NAIC issued a statement that Executive Life was and I quote, "in no imminent financial danger." Indeed, NAIC passed a resolution criticizing the State of New Jersey when their regulators sought a $500 million deposit from both Executive Life of California and Executive Life of New York in order to protect New Jersey policyholders.

Some of our questions might go unanswered today. We invited Fred Carr, chairman of First Executive, to testify. He refused. We invited all three rating firms, A.M. Best, Standard & Poors, and Moody's to appear. They too refused.

With or without them, we will eventually get our answers, because insurance is too important in people's lives and the consequence of the failure like Executive Life, too severe to ignore.

Many of the comments being made about the solvency of the insurance industry today are a haunting refrain of what was being said about the savings and loan industry just a decade ago or about the solvency of the bank insurance fund just a year ago.

Events like the failure of Executive Life raise concerns as to the adequacy and the effectiveness of State insurance regulation. The cases clearly raises doubts that existing State regulation may not provide the protection policyholders and taxpayers need.

Let me now defer to Senator Exon, a member of the full committee, who joins us this morning.

OPENING STATEMENT BY SENATOR EXON

Senator EXON. Mr. Chairman, thank you very much.

I am here today to listen to the testimony very carefully of the excellent witness list that you have provided for the subcommittee today, despite the fact that some of the "star players" that you mentioned decided not to come.

I can understand their reluctance. I think this is a very timely meeting, and it is time indeed that we get into this matter.

The second panel includes Mr. William McCartney, the Insurance Commission of the State of Nebraska, who is well versed in these affairs.

I listened very carefully to your opening remarks, Mr. Chairman, and I agree that there is some concern here. Certainly, I do agree with you though, and I thought it was emphasized very well in your remarks, basically the insurance industry as a whole is still, in my opinion, in good shape, but there are some danger flags, caution flags at least, coming up around the edges.

The subject of the hearing today is a classic example, in my opinion, of the failure of the management agencies, the rating agencies. It is a failure of what I have always placed my stock in as Governor of Nebraska and ever since I have been here, and it was the failure of the regulatory agencies, but primarily, I suggest, the responsibility of the National Association of Insurance Commissioners, that was once a very strong organization that yielded a great deal of weight.

If you would take time to check back through the testimony over the years, you will find that this Senator has been increasingly critical of the lack of drive and determination that I think was well in place at one time, with the National Association of Insurance Commissioners.

As much as anything else, I think we should be focusing on what happened, what happened, Mr. Chairman, to that organization that at one time thrived and one time was looked upon as the model of keeping control or regulation of the insurance industry out of Washington, DC, out to the States.

I must say that I am somewhat convinced, upon recent developments, that the National Association of Insurance Commissioners have seen the error of their ways, and may be coming back into a very effective group that I still think would be better than leaving up to Federal regulators.

While it is very important that we have these kinds of hearings, to focus attention on the matter, I still have some reservation, Mr. Chairman, about solving this by having the Federal Government take over the regulation.

The Federal Government had longstanding and supposedly effective regulators and inspectors in place to take care of the savings and loan industry and lo and behold, even with all the regulations that we had in place, it blew up in our face.

Now we are having some increasing difficulties in the banking industry itself. And I heard on the news this morning that the President was appealing to key members of the Banking Committee to not do anything about reestablishing some degree of soundness in the Federal Deposit Insurance Corporation Fund unless they went along with what the President thinks are necessary changes that must be made in the banking industry.

Therefore, I just want to start out this hearing by saying that I am delighted that you called it. I think it is going to focus some attention on things and force us, maybe, to make a decision.

This is one Senator though that still have some reservations about thinking the salvation of all of that is to simply turn it over to the Federal Government that has done such a miserable job in related fields, and I am not sure that the ones who can solve it are here in Washington, DC, nor will they be successful here in Washington, DC, if we somehow pass some regulations and say, "Now we have taken care of that problem and laid it to bed forever." It does not seem to work that way.

Thank you, Mr. Chairman. I am delighted to see my friend and colleague from Ohio here, and I am looking forward to his testimony.

Senator BRYAN. Thank you very much, Senator Exon.

Senator Metzenbaum, who joins us this morning as the leadoff witness, has long had an interest in insurance regulation, and we are delighted to welcome him to the full committee this morning. Welcome, Senator.

STATEMENT OF HON. HOWARD W. METZENBAUM, A U.S. SENATOR FROM OHIO

Senator METZENBAUM. Good morning, Mr. Chairman. Good morning, Senator Exon. I want to thank you for this opportunity to testify on the issues raised by the failure of Executive Life Insurance Co.

Mr. Chairman and Senator Exon, I want to applaud both of you on your very astute observations. Mr. Chairman, you made an excellent opening statement. You hit the issues right on the head, and it bodes well for future action.

The question of what we do is a matter that is not something that we ought to be thinking about a year from now or 2 years from now or after the horse is out of the barn or after we see more insurance industries tumble. The challenge is before us now, and I recognize, Senator Exon, that indeed a lousy job—and I use the word appropriately—was done with respect to savings and loan regulation.

But do not overlook the fact that it came about during a period of time when the President of the United States took the position that let businesses do anything they wanted. Just do not bother them. Keep the hands off. That position let businesses operate in any way that they want, and the savings and loan regulators, they had the authority but they did not have the brains nor the guts nor the propriety to see to it that there was adequate regulation, and we know what happened as a result.

I believe it is crucial, frankly, that all affected congressional committees closely monitor the unfolding tragedy of Executive Life. But let us not kid ourselves.

Executive Life, at this moment, is more than a symbol, rather it is a indicator of the kinds of problems that exist out there. As you said already, Mr. Chairman, one of other the companies, American Express, is also being closely examined by California regulators. And there are other companies.

We know that that giant, Equitable Life, is now—long considered a giant in the industry, is out there now talking about changing from a mutual to a stock company in order to bring in more dollars. We have read the stories about Travelers, in which we always thought everybody was protected under the red umbrella, but now we hear that they are having financial difficulties. And we do not know about how many others there are out there.

The failure of Executive Life is a symbol of a failure that may affect us all, but Executive Life itself is a failure that will affect us all. Ultimately, it will be consumers and taxpayers who pay the price for Executive Life's reckless behavior and the State insurance departments' regulatory neglect.

You are right. Most people do not recognize this, and you hit the nail right on the head when you said in these State funds, which provide for some contribution, not nearly enough has been paid to cover the problem, but whatever is paid will not come from the life insurance companies. It will be deducted in almost all instances from the taxes that they pay to the State and once again, Joe Sucker, taxpayer, will be on the line for the failure of somebody in Government to do that which he or she should have done.

Executive Life has issued over $60 billion in life insurance policies and $3 billion in guaranteed investment contracts. It is estimated that the company's assets are approximately $10 billion, 60 percent of which is invested in junk bonds. The fate of 245,000 policyholders in 45 States is at stake.

There are 75,000 retirees who are now receiving 70 percent of their monthly pension checks, and it is not certain how long that will continue. Three corporations that bought those pensions have indicated that they would carry them for a short period of time and bring it up to 100 percent. But in all of the other companies, and I think there are about 50 of them, nothing is happening and they are getting 70 cents on the dollars.

Perhaps the most distressing aspect of this situation is that it all could and should have been avoided. For years, individuals knowledgeable about the insurance industry have been sounding alarms about Executive Life. Not the rating firms that you mentioned, but others have raised those concerns.

It was no secret that a majority of Executive Life's assets were invested in junk bonds and that the company relied on questionable reinsurance agreements and other accounting practices to bolster its financial statements. One of the key lessons of this saga is how the State insurance departments, particularly the California Insurance Department, failed until last month to take appropriate action against Executive Life.

Now, at first glance, it appears that Executive Life's troubles began with the down turn in the junk bond market in 1989. That is not the fact. Because upon closer analysis, it becomes undeniably clear that Executive Life was in financial trouble, if not insolvent, in as early as 1983. Unfortunately, during all these troubled years, State insurance departments allowed Executive Life to grow by spectacular leaps and bounds from $2 billion in life insurance in force in 1990 to over $60 billion in 1989.

The sad truth is that back in 1985, when the California Insurance Department, in conjunction with the insurance departments of New York, Tennessee, Texas, and Missouri, when they reviewed the company's financial condition for the years 1980 to 1983, Executive Life was insolvent. The company had relied on certain reinsurance agreements in order to claim a positive net worth.

Even though the departments found these agreements, the department said the agreements were insufficient to reduce Executive Life's liabilities. Notwithstanding their finding to that effect, the department allowed the company to record them as good reinsurance.

They actually said in so many words that this reinsurance with other companies, with the parent company, that it was not valid because there was an out because the parent company did not have to pay, and the examiner pointed that out and put it into his report.

Notwithstanding that, the insurance departments of those five States did not do a thing about it and let Executive Life carry on and gave them a stamp of approval. The effect was to give the company a positive net worth.

If you could not collect on the reinsurance, then what value was it? The company was insolvent. Even though the five State departments knew the agreements were worthless and the company had a negative net worth, they did nothing.

What did its accountants do, as you have already pointed? They did not do anything. They went along with the phoniness of those reports, and as you have already pointed out some of them wound up going to work at high salaries for Executive Life.

Now when that happened, did the California Insurance Department take any action to rein in Executive Life? No. At no point did they do so, nor did any of the other States. The company was allowed to grow without limit, and again in 1988, the California department found that Executive Life was on the brink of insolvency as of the end of 1987.

Again, the department allowed the company, on the last day of 1987, to rely on an accounting gimmick called "surplus notes" to give the company a positive net worth. In fact, the department had every reason to worry that the company was in the most serious financial condition. Unfortunately, they paid no attention to these surplus notes and the fact that it was just a phony deal.

Now I came out of the business world. Before I came to the U.S. Senate, I headed three companies, one on the New York, one on the American, and one on the over-the-counter market. I tell you that when I read about surplus notes, I could not believe what I was reading because surplus notes are just a gimmick. You get the money from another company, you promise to pay it back, and somehow you call that a surplus note and you do not have to show it as a liability. But you owe the money.

Now I do not know who came up with this gimmick, but I do know this, that in the insurance industry today there is something like $4.5 billion of those surplus notes, and no insurance commissioner that I know of in this country is doing a darn thing about it.

Now let us see what really happened in some of these cases. John Smith decides to take over an insurance company—take over a private company—and John Smith does not have enough money to do it, so he says he is going to move in on the company. He is going to pay *x* million dollars, and in taking over the company, he is going to restructure it and he is going to issue junk bonds.

In the case of Executive Life what occurred was that some of the junk bonds in many of these instances were bought by Executive Life. Then the LBO slick artists came in, terminated the pension plan, took out the excess money in order to help make the leveraged buyout and then took that which was necessary in order to buy annuities and put it into Executive Life.

So, you had this round the merry-go-round deal, where Executive Life sold the big annuity contract. The LBO artists came in, took over the company, sold some of the junk bonds to Executive Life, and who wound up getting stuck? Of course, the policyholders, and nobody raised any questions.

Now we all know the story after 1983, they were insolvent, and after 1988 they were insolvent, but everybody thinks that in this country the reason Executive Life went belly up is because in 1989 the junk bond market began to fail and Executive Life's financial condition was beyond repair. That was not the case. Executive Life was an insolvent company since 1983.

The moral here is that Executive Life's financial status was known as early as 1985 and could have been remedied instead, the California Insurance Department and the four other States that I mentioned, looked the other way. And now 6 years later, we are faced with the largest insurance company failure in history: 170,000 policyholders and 75,000 annuity recipients are at risk of losing their life and health insurance benefits.

My Subcommittee on Antitrust, Monopolies and Business Rights recently held two hearings on State insurance regulation, a subject the distinguished Senator from Nebraska mentioned. These hearing reveal the inadequacy of such State regulation. State insurance commissioners rarely if ever, verify company-reported asset values.

They are not doing anything about surplus notes at this moment. They did not do anything with the invalid reinsurance agreements—noncollectible reinsurance agreements—I would not call them invalid, but they are noncollectible reinsurance agreements—that Executive Life had.

Moreover, the 50 States use a wide asset valuation method. State insurance departments are woefully understaffed in their efforts to regulate 2,400 life insurance companies and 3,800 property and casualty companies.

Overall, our committee has found serious evidence of lax regulation, outdated accounting methods, overvalued assets and, in some instances, low capital requirements. Our subcommittee will continue its extensive review of State regulation of insurance during the balance of this congressional period.

There is also significant concern that the Department of Labor was asleep at the switch while pension plans invested in Executive Life, either by purchasing guaranteed investment contracts or by annuitizing pension plan participants.

Federal law requires that pension plan investments be made in compliance with strict fiduciary standards and solely based upon the interests of workers and retirees. But a Department of Labor advisory council found that many pension plans invested with unrated insurance companies and purchased the cheapest product available. Even though numerous individuals, including myself, have urged the Department of Labor to take action, to date they have done nothing.

In closing, Mr. Chairman, let me say this. I think that the action of this committee in moving forward promptly is very commendable, and I do indeed commend you publicly for doing so.

I say to you that I believe that Congress failed to meet its responsibility when the Reagan administration was decontrolling the savings and loan industry and letting it just fly without any adequate regulation.

I am frank to say that I am concerned as to what has happened in the banking industry today, and I disagree with my President when he suggests that we should not be strengthening the FDIC to whatever standards are necessary in order to protect the depositors and that we turn instead to the Federal Reserve Board or some other kind of gimmickry in order to permit the banks to carry on.

I think we need to face that issue squarely, and my guess is that we will do so on the floor of the Senate.

But I want to say to you that in connection with this subject, my committee will conduct hearings and we will expose the weakness in the insurance industry. And from your opening statement, Mr. Chairman, it is obvious to me that you are aware of it, that you are very much on top of the issue, and that you intend to that which has to be done.

Let me say to you as one Senator in this body, I believe that tomorrow is too late for us to be moving forward. I am not certain that we need Federal regulation and I have not advocated that, but I am not certain that we do not.

I will tell you what we do need. We need the insurance industry to step up to the bar, to step up to Congress, and say "Look, we know there are problems and this is what we will do or what we suggest you do." What they are saying is, "We are running away from the problem. The industry is strong."

The industry is not that strong, and State regulation is a failure. It is not working. The insurance regulators—some are good but there are some exceptions. The fact is that the State regulators, first of all, do not have the knowledge to do that which has to be done in connection with this industry. They are not that well staffed, and they are not going to get that well staffed overnight.

Second, I am not sure that they have the resources to do so. The States do not provide them with that much in resources.

Last, I am not at all certain that many of them are prepared or have the will to do that which has to be done. Too many of them, like those from the accounting firm you mentioned earlier, wind up going to work for the very insurance companies that they have been regulating a week, a month, or a year before.

I say to you, Mr. Chairman, I believe that Congress has to deal with this problem promptly. This subject has a sense of urgency about it. There is no more powerful economic industry in the Nation than the insurance industry. They have an impact upon the entire economy of this country, and I think that we all ought to be working together. I pledge to you my willingness to work with you and the members of this committee, to get the insurance industry to do that which has to be done. I am not sure they are willing to do that, or that they will come in and indicate a willingness to do so. If they don't we have to take more draconian steps.

Thank you very much, Mr. Chairman.

Senator BRYAN. Senator Metzenbaum, we appreciate your very forceful presentation this morning. And let me assure you this committee will be interested in working with you so that we can get to the bottom of this and take the appropriate action needed to correct the situation.

And I thank you very much.

Senator METZENBAUM. Thank you very much.

Senator BRYAN. Senator McCain has joined us this morning. Let me defer to him for any opening comments he might care to make at this point.

Senator MCCAIN. I have no opening statement, Mr. Chairman. Thank you for holding this hearing on this very important and critical issue.

I just had one question, Mr. Chairman. Have we invited any administration witnesses to appear today?

Senator BRYAN. We have not. We, as you know, Senator McCain, had a hearing earlier in which we had some general overview. We will have this hearing today and one on May 9. And we will probably have some followup hearings on that as well.

Senator MCCAIN. Knowing the chairman as I do, I am sure that we will have ample input from the administration on this issue.

Senator BRYAN. I would indicate that we did have testimony from members of the Commerce Department at our earlier hearing this year. And if need be we will be happy to call some additional people back as well.

Senator MCCAIN. Thank you very much, Mr. Chairman.

Senator BRYAN. Let me now defer to Senator Ford who joins us.

OPENING STATEMENT BY SENATOR FORD

Senator FORD. Thank you, Mr. Chairman, I will not take but a minute. I am interested in moving on. Some people will want to try to bash the insurance industry and want Federal regulation and a commission up here to regulate all insurance businesses—take it away from the States. And if the past track record of savings and loans and banks is any indication, I think you better leave it to the States. And we do have three Governors here that—former Governors—that operated very well under those circumstances.

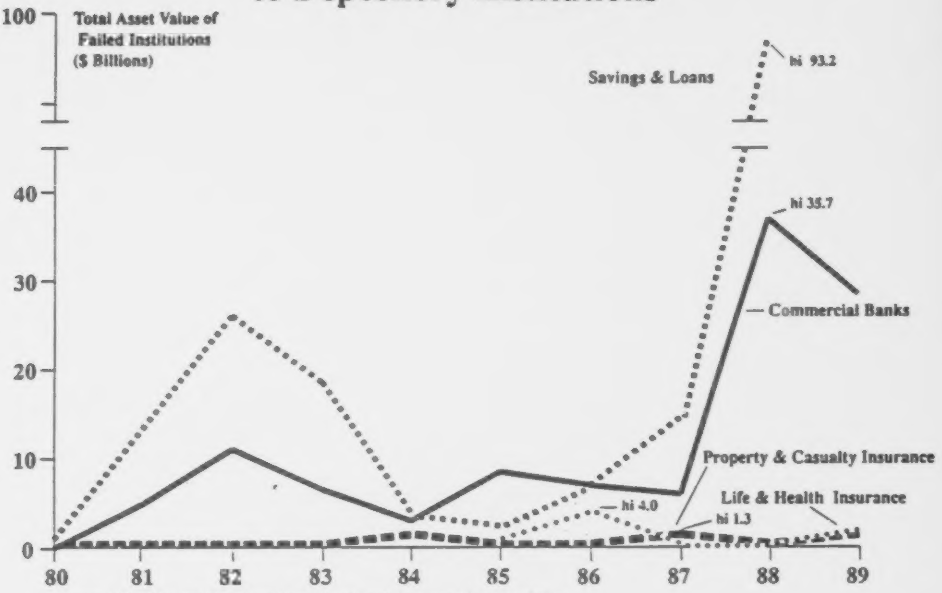
And I would hope that we would not let some of the so-called bashers, who just for the sake of bashing people—and I have a little graph here that at some point I will put in the record which shows the insolvencies of insurance companies compared to everything else. And they have been on the straight line practically none compared to—since 1980, the last 10 years. And they are very small in comparison to depository institutions.

So, I look forward to some of the testimony and wanted to indicate where I was coming from, Mr. Chairman.

[The information referred to follows:]

Exhibit Two

Insurer Failures Small in Comparison to Depository Institutions



Sources: NOLHGA FDIC Federal Home Loan Bank Insurance Services Office

2. If insurers are generally financially healthy, why has the issue of insurer solvency

Senator BRYAN. Senator Ford, we thank you very much, and at the appropriate time, at your request, that graph will be made a part of our record.

Senator EXON. Mr. Chairman, may I add just a thought or two?

Senator BRYAN. You certainly may, Senator Exon.

Senator EXON. I am disappointed that I did not realize that our distinguished colleague from Ohio was leaving right away. I did wish to ask some questions about his testimony. I think it is appropriate at this time that I enter into the record a story from the Omaha World Herald of May 2, which is right on point here. Executive Life NIFA bonds are in default. NIFA bonds was an instrumentality of the State of the Nebraska that was used back I think in 1985 or 1986 to set up a fund by going around the State's prohibition against bonding the State for individual purposes.

This particular scheme that ended up tied in very closely with Executive Life that we are looking at here today points up some of the points made in a very articulate fashion by Senator Metzenbaum. NIFA bonds, Nebraska Investment Finance Authority, were floated through a bonding company without the guarantee of the State of Nebraska, but floated by the State of Nebraska, with the name of Nebraska prominently in its title. I do not believe that many of the bondholders were misled into thinking that the State of Nebraska were behind these bonds. But of course that may have been the case with some of them.

In any event, the money was raised through a bond effort supposedly to let the board that was appointed loan this money at attractive interest rates to farmers in Nebraska that were going through a particularly stressful time with regard to the ability to raise capital-type loans to carry on their investment. As it worked out, and the reasons are not fully clear as yet, no farmer loans were made. But the bonds had been sold, and the money therefore was invested at a "attractive rate of interest" with Executive Life. It seemed like a system that would make everyone happy, because Executive Life would be in essence guaranteeing all of this and they were going to give us a high rate of interest. And we would have the money there assembled in case we ever needed it.

The point that I want to make here is—and I was particularly interested in the dates that Senator Metzenbaum indicated that by hearings in his subcommittee that Executive Life may have been insolvent way back in the 1985 to 1986 period. That makes a very good case in point.

I am convinced that those in charge of the Nebraska Investment Finance Authority at this time did not know of, I hope, the precarious financial situation or the potentially precarious financial situation that involved Executive Life at that time. Had they known that I think they would not have invested that money in that company that obviously had a very, very risky investment policy with junk bonds. Junk bonds are wonderful if things all work out. But the very name indicates that they are a high-risk type of instrument.

Nevertheless, I still want to say—and the point I wanted to make with the Senator's testimony—toward the end of his testimony, Mr. Chairman, he went through a whole series of failures on the part of the regulatory authority with regards to the S&L mess that we are still in. And now to a lesser extent, hopefully not as extensive an extent, into the banking industry itself.

I think when you starting listing all of those failures, that does not make the case for Federal intervention along the lines that some have suggested. In other words, the Federal Government taking over the regulation of the insurance industry. If we have learned anything, it seems to me, the higher we get in the Government structure, the less likely we are to discovery the discrepancy.

The testimony by the Senator from Ohio himself—and I wish he was here so I could ask him these questions, but I think it is a case in point to be made—everything that he has said would seem to indicate to me that while we have an obligation to get into this, the salvation is not Federal takeover. And I think that is a very, very dangerous step that we are contemplating at this time out of the fact that enough has not been done in the past.

I would simply say possibly as a means of some type of a compromise along the line to get ourselves out of this mess that we are in, and yet discharge our responsibilities which I recognize we have is to come up with some kind of an overview, leaving the decision strictly in the States but possibly have an overview of some kind by the Federal Government, which might be a happy compromise, certainly as opposed, in the view of this Senator, to outright Federal takeover.

I also was quite concerned about the taxpayers bailing out the investors' insurance policies. That is not the case in my view; that should not be the case in my view. And I think it is wrong if we simply say, "OK, we had an S&L mess and look at that. And now we have a potential bank mess; look at that. Now, it follows that we should do something about the insurance industry." There is a distinct difference between S&L's and banks. The Federal Government rightly or wrongly are on the hook for up to $1,000 per account in both S&L's and in banks. The Federal Government is not on the hook and should not be on the hook, and therefore, the taxpayer should not be on the hook, in my view, with regard to insurance companies. When you buy insurance as most of us do from time to time, then I think you have an obligation to understand you are taking a risk. And when you take that risk you are depending upon the regulators at whatever level to discharge their duties much better than they did in the S&L and the banking business.

So, I would simply with that statement like to enter into the record to show that we have a case in point on this right in Nebraska by introducing the article that I reference in the Omaha World Herald of May 2 at this point.

Senator BRYAN. Without objection the article will be made a part of the record.

[The information referred to follows:]

[Omaha World-Herald, May 2, 1991]

Executive Life NIFA Bonds Are in Default

(By Jim Rasmussen)

Executive Life Insurance Co. missed an $8.9 million interest payment due Wednesday to holders of $200 million in Nebraska Investment Finance Authority bonds.

The trustee for the bond issue, Norwest Bank Minnesota, issued a notice of default Thursday to bondholders, saying the California firm had missed the payment.

California regulators seized Executive Life April 11. The company and its parent, First Executive Corp., were weakened by junk bond investments, officials have said.

California has placed a moratorium on Executive Life payments on guaranteed investment contracts such as those that held the Nebraska bondholders' money.

Joseph J. Skudlarek, an Omaha attorney for NIFA bondholders, said he had been expecting such a default for more than a year. He said a lawsuit by bondholders contends the NIFA issuance was a scheme designed to raise money for NIFA and bond underwriters, including defunct junk bond kingpin Drexel Burnham Lambert.

"The whole scheme has kind of been overlooked as not as important as it really is to Nebraskans," he said. "I think this will certainly help bring it to the forefront."

Skularek is attorney for the suit by bondholders, including Nebraskans Timothy and Marie Devlin on behalf of all the bondholders. The suit was filed in April 1990, contending that the bond issue was a scheme to market junk bonds in the guise of municipal bonds and was a fraud to investors and the public.

The suit has been consolidated with other similar suits in a Louisiana court.

The bond issue's stated purpose was to provide agricultural loans to farmers, but none of the $200 million ever was loaned to farmers.

NIFA officials have said the money was to be invested with Executive Life for a time to earn interest. Withdrawals could have been made for farm loans. Half the money—$100 million—was to be held in reserve by Executive Life and was not available for the farm loans.

Skudlarek said loan underwriting requirements were so stringent that no farmers wanted to apply.

He said NIFA and the underwriters should have told investors that the bond proceeds would be backed for a time by high-risk, high-yield bonds known as junk bonds.

"That's securities law," he said. "If a fact is material to an investment decision, it must be disclosed. If they (investors) had known there was going to be an instant where it was backed by junk bonds instead of farm loans, the investment decision would have been different."

Larry Bare, executive director of NIFA, said Thursday that official statements of the bond issue told investors where their money was going. The official statement said the money would be invested in guaranteed investment contracts with Executive Life.

"Whether the investment practices of that company needed to be disclosed or not is, I guess, an open issue," Bare said.

NIFA said the default would not affect any of its other bond issues, including single-family mortgage bonds.

Bare said the moratorium on payments was one measure California regulators have taken to try to ensure the long-term survival of Executive Life. A long-term solution to the company's problems may determine whether bondholders ever receive their interest and principal, he said.

Skudlarek said bondholders have another hope: that a company or pool of companies would buy Executive Life and rescue it from its financial difficulties.

The Norwest notice to bondholders said the bank was "exploring appropriate measures to take in view of the existing payment default."

Norwest officials declined further comment.

Norwest Corp. attorney Tim Carlin has said the bank could pursue a variety of remedies for bondholders, including a lawsuit.

Senator BRYAN. Senator Gorton joins us this morning. Let me defer to him for any opening comments he cares to make.

OPENING STATEMENT BY SENATOR GORTON

Senator GORTON. Thank you, I have a brief opening statement which I ask be entered in the record.

Mr. Chairman, I would like to thank you for calling these two hearings on life insurance company insolvencies.

Today's hearing on the Executive Life Insurance companies is particularly timely and relevant to the committee's work on insolvency. In the wake of the savings and loan crisis, it is important for the committee to exercise its jurisdiction over the insurance industry to determine if it is stable, and if the current regulatory structure is adequate at guarding against widespread insolvencies.

The life insurance industry is a powerful force in our economy. With a bond portfolio of over $730 billion, it is a major investor in all financial markets. Life insurance provides an essential service for all Americans. Moreover, it offers a major source of investment opportunities for pension funds.

First, the committee will examine Executive Life. If the California company is declared insolvent, it will have enormous implications for the state regulatory and guaranty systems. Understanding Executive Life is essential to our overall understanding of the life insurance industry. Next, we will attempt to discern whether the overall industry is in stable financial condition. Effective regulation is a crucial part of the effort to maintain a viable industry.

Today's witnesses and the witnesses at the May 9 hearing will provide important insights into these questions, Mr. Chairman. I look forward to hearing their testimony.

Thank you.

Senator BRYAN. Thank you very much. We are pleased this morning to have as our first panel the newly elected Insurance Commissioner from the State of California, Mr. John Garamendi, who joins us and the Superintendent of the Insurance Department from the State of New York, Mr. Salvatore Curiale, two men who have been in the forefront of the problems that confront Executive Life.

Gentlemen, it is my pleasure to welcome you here this morning.

Mr. Curiale, the Superintendent from New York, will be accompanied by Terry Lennon, who heads up the Life Health Division for the New York Insurance Department.

Gentlemen, let me welcome each of you. Let us begin. Mr. Garamendi, if we might have you offer your testimony, and I would state to both of you that for the record your full testimony is made a part of the record of this proceeding. And I know, Mr. Curiale, you have made some changes to it, and those changes are reflected as well.

STATEMENT OF JOHN GARAMENDI, INSURANCE COMMISSIONER, STATE OF CALIFORNIA

Mr. GARAMENDI. Thank you very much, Senator—Senators. I am John Garamendi, the first elected Insurance Commissioner in California. I stress elective not as a point of pride for me personally, though it is that, but as a tribute to the citizens of the State of California. After years of frustration and anger, the voters in my State decided they had had enough. And in 1988 they approved proposition 103, demanding across-the-board insurance industry reform and in doing so created my elected position.

I am at pains, Mr. Chairman, to point out that I was not elected until November of last year—did not take office until a scant 4 months ago. Sad to say, in the 2-year interim before I took office the California electorate's clear mandate for insurance reform enjoyed something less than aggressive implementation that it deserved.

In these past 4 months, however, we have done much and our detractors, some say, too much to assure fair rates, swift enforcement of consumer protection laws, provide useful price comparison information, improve handling of consumer complaints, and ensure that the solvency of insurance companies is at hand.

One of the most important responsibilities I have is in this latter area of maintaining the solvency of companies that do business in our State. And of course, it is this subject which promoted your invitation to me to appear today to explain my actions of less than a month to go concerning one of the Nation's largest insurers, Executive Life Insurance Co., in our parlance, ELIC.

In a word, we seized the company. More legalistically, on April 11 we sought and obtained a court order of conservationship. Having determined that the company was in a hazardous condition—hazardous condition, by the way, is a term of art and it is the least threatening of three conditions, the other two being impaired and insolvent, any one of which of these three can prompt conservation.

We did not take this extraordinary action lightly or eagerly.

Some background: within a week of being elected last November, I met with the outgoing, appointed insurance commissioner and her staff to discuss a number of issues, including the Executive Life situation. Executive Life, of course, had been much in the news. You spoke of that earlier. It is a company that had mushroomed in size in the early 1980's. It hit the papers in 1989 when it attempted to repackage some $7 billion in junk bonds to reduce its reserve obligations under the insurance laws of the State of the California.

Even before that, back in 1987, the company's New York unit had run headlong into regulatory problems in that State. In early 1990, the company had to announce a $500 million plus charge to its profits because of defaults and losses in its junk bond portfolio.

The SEC was investigating possible security violations, and a committee of the California Legislature had launched an investigation.

The negative publicity from all of this activity was enormous. It produced a run on the company, and policy surrenders and lawsuits occurred. Other State insurance commissioners began to pressure California for more scrutiny of Executive Life. The department of insurance responded by requesting that the company obtain an independent actuarial study of case flow projections under a variety of worst-case scenarios.

The rosiest of all the possible interpretations was put on the company's unpublished first quarter SEC report and in various public statements. In other words, they took the best of the bad news and published that. The prior administration, for its part, concluded that while the company should be more closely watched and supervised, it could now and in the future deal with the cash flow drain that it was experiencing.

Upon taking office in January, I immediately ordered a new regime of regulatory control. First, I assembled a crisis management team to see that all the relevant information on the company was assembled and shared.

Next, I ordered an immediate and thorough evaluation of the current market value of the company's junk bond investment portfolio. And finally, I reached out to experts in the financial world to evaluate the company and explore strategies to deal with the situation.

In March I received the first preliminary reports from my team. The picture that emerged was not pretty. Of Executive Life's $10.1 billion in assets at that time, fully $6.4 billion was invested in junk bonds.

Meanwhile, the company had 170,000 life insurance policies in force, with a face value of $38 billion, creating a $2.5 billion statutory reserve liability; 75,000 annuitants required another $2.5 billion in reserves. Over 300 guaranteed investment contracts, known as GIC's were worth more than $3 billion.

All of this happened at time of record junk bond defaults, crashing values, not to mention a rash of celebrated junk bond scandals and criminal actions. Worse, policy surrenders continued to grow throughout 1990.

It appears that previous analysis relied on book values and paper incomes, which enabled ELIC's management to constantly reassure the public that the company was sound, if not happy, and it was fully capable of meeting its obligations. And as we know now, that was not the case.

On that score, I am not unmindful of the defense offered by the company's chief executive officer, Fred Carr, here on Capitol Hill in June of last year. His defense was that the current market value of Executive Life's portfolio is simply irrelevant to the question of its long-term cash-flow capability.

My own belief is that the quality of a company's assets is absolutely key, and I have specified that our outside analysis and our own internal teams now focus on that essential element: That is the very real world.

By late spring, ELIC's situation was clearly deteriorating. The NAIC reclassified some of the company's junk bondholdings, requiring a significant write-down of its assets, that is to market instead of book value, and that required a corresponding increase in reserves.

By the end of March, Price Waterhouse expressed doubt that the company's parent, First Executive, was a going concern, and pointed to the worsening legal and regulatory problems in its Security and Exchange Commission's 10(k) filing for the first quarter of this year.

Reluctantly, we concluded that Executive Life, its policyholders, and its own stockholders needed our protection, and the conservatorship followed.

We determined that liquidating the company would be lengthy, expensive, and very damaging to the interest of the policyholders. That is why we have initiated a strategy to revitalize Executive Life, so that it will become a viable, ongoing company. In other words, we set out to truly conserve the company.

Accordingly, we are actively engaged in negotiations with a French concern to acquire the company, and meanwhile, we are maintaining direct control over all significant transactions in the company.

I am encouraged by the advice that the California Guarantee Fund will be able to cover policyholders in our State. We have sought to resume payment of policy benefits, even as we have temporarily suspended policy surrenders.

I might say, Mr. Chairman, that this task is enormously complicated by recent, and I believe precipitous, action by the Internal Revenue Service. On April 19, just days following our conservatorship of the company, a letter, unceremoniously faxed to Executive Life Insurance's Los Angeles headquarters, the IRS summarily demanded immediate payment of $643 million for the tax years 1981, 1982, and 1983.

Ostensibly, $249 million of that is for taxes owed and $349 million is for penalties and interest. Just why the Service took a decade to assert its claim, whatever its merits, is unclear to me.

But I do know that if the claim is perfected, the policyholders that I am sworn to protect will be in deep trouble. I am not now in a position to predict with certainty what will happen in the Executive Life Insurance case.

For the future however, I am revamping our organization to develop an early warning system that will alert us to potential problems in time to remedy them, to ensure that guarantee funds which help ease the trauma of insolvent companies are adequate to meet their obligations, and to embrace the efforts of other States and the Federal Government, to improve cooperative relationships necessary to deal with companies which do business in dozens of States and foreign countries.

I applaud the NAIC's efforts to toughen its standards and to encourage uniform application of those standards throughout the Nation. At the same time, I suspect that Federal attention in this area may be necessary.

Mr. Chairman, I especially welcome your interest, and I am hopeful that I may be of help to you and your committee as you pursue it.

Thank you very much. I will be happy to answer questions that the subcommittee may have.

Senator BRYAN. Thank you very much, Commissioner.

Let me also note for the record that Commissioner Garamendi is joined by staff member, Rick Baum, and we are pleased to have you with us today.

Superintendent Curiale, am I pronouncing your last name correctly, sir?

Mr. CURIALE. Right on the money, sir.

Senator BRYAN. Great. We will hear from you now, sir.

STATEMENT OF SALVATORE R. CURIALE, SUPERINTENDENT, NEW YORK STATE INSURANCE DEPARTMENT, NEW YORK, NY; ACCOMPANIED BY TERRENCE LENNON, CHIEF, LIFE INSURANCE BUREAU, NEW YORK STATE INSURANCE DEPARTMENT, NEW YORK, NY

Mr. CURIALE. Mr. Chairman, members of the committee, my name is Salvatore Curiale. I am the Superintendent of Insurance for the State of New York. Beside me is Terrence Lennon, Chief of the Department's Life Insurance Bureau, which is responsible for the regulation of the life insurance industry in New York.

You have asked us to comment today on the condition of the life insurance industry; our actions with respect to Executive Life Insurance Co. of New York, ELNY; and what if anything, the recent regulatory actions with respect to ELNY and its parent company, Executive Life Insurance Co. of California, ELIC, portend for the life insurance industry and for its regulation.

My oral presentation will summarize the more detailed testimony that has been provided to you. In the course of that testimony I have referred not only to actions by the New York Insurance Department, but also to actions of the National Association of Insurance Commissions, the NAIC, an association of State insurance regulators, in which New York is an active participant.

During the last decade, the life insurance industry has undergone dramatic changes. It has evolved from a mature business with stable risk elements and generous profit margins, to a business marked by instability of risk and evaporating profit margins.

This has come about through a revolution in the market place precipitated by the dramatic rise in interest rates in the late 1970's and early 1980's. The life insurance industry scrambled to satisfy a consumer whose transformation from a saver to an investor was being propelled by a pyrotechnic interest rate environment.

New products were developed as the marketing emphasis shifted from selling security to selling at least partially, a rate of return.

The public became less interested in solidity and service, seeking instead a maximum return on its dollar. In this environment, product margins began to shrink precipitously, as companies struggled to compete.

Thus, at the offset of the final decade of the 20th century, an industry that had flourished in this century is now struggling to redefine itself.

During the past decade, many life insurance companies have seen their real capital shrink. Many are being carried by the earnings derived from older business and are not earning sufficiently on their new business to carry them into the future.

The responses from life insurers to these conditions have varied. Many of them have been positive and have led to better performing companies. Other have been risky and have led to regulatory actions.

However, there are real signs of improvement throughout the industry. Reduction of expenses has become widespread and better management structures have begun to take hold. The decade of the 1990's will see a significant consolidation in the industry as the problems of the 1980's are gradually managed.

The subcommittee has asked for our comments with regard to the department's request that the court place ELNY into rehabilitation. The department's actions with regard to ELNY go back to the early part of the last decade.

ELNY is a good example of a company responding to its problems in a way that created greater risk to its policyholders and called for regulatory action. For example, ELNY's investment strategy was one of the primary factors in prompting the department to promulgate its junk bond regulation in 1987.

In addition, the department has, through a series of actions, caused ELNY to remove from its balance sheets all financial reinsurance, a former reinsurance that artificially inflates surplus.

Finally, both in the report on examination filed on May 2, 1990, and in our recent actions, we have indicated that the company's reserves required strengthening because of a mismatching of cashflows from assets and liabilities.

Despite the department's action, which resulted in a number of heavy fines, and a capital infusion of over $200 million, the company's concentration of investments in junk bonds left it with a high degree of risk.

The department's junk bond regulation did not require the divestiture of bonds held because the return on those investments were assumed in pricing the company's annuity contracts, that is, its liabilities. As a practical matter, the regulation prohibited the acquisition of new junk bonds until the company was below the limit.

This caused the proportion of junk bonds in the portfolio to decrease from approximately 75 percent prior to the regulation in 1987 to approximately 50 percent by 1989. However, the heavy surrenders which began in early 1990, took for the most part nonjunk assets out of the company which caused the proportion of junk bonds in the portfolio to increase again to over 60 percent, although the amount of junk bonds remained relatively level.

Early in 1991, the publicity attendant to ELIC's and ELNY's problems with their portfolios was at an extremely high level. Speculation regarding regulatory action was printed daily and surrenders began to mount.

After meeting with the company to discuss its asset/liability cash-flow matching, the department instructed ELNY on April 3, to refile its financial statement in all jurisdictions in which it was licensed, showing an additional reserve of $125 million and indicating that discussions with the New York department with respect to possible additional reserves were continuing.

We also instructed ELNY to discontinue writing all new business until it had demonstrated to the department that such new business was self-supporting and not eroding the position of current policyholders.

The department announced these actions to the press and to all State insurance departments so that the public and the regulators would be aware of these actions as soon as possible.

On Thursday, April 11, the California Commissioner, Mr. Garamendi, went to court to begin the process of placing ELIC into conservatorship. Press coverage of this event precipitated an avalanche of surrender requests at ELNY.

By Monday, April 15, crowds of policyholders were gathering at ELNY's offices. The hemorrhaging was having a destabilizing affect on the company and had the potential of disadvantaging those contract holders without surrender rights.

These surrender requests would result in nonjunk assets being liquidated, thus, increasing the percentage of junk bonds supporting the remaining nonsurrenderable policies.

Therefore, on the afternoon of April 15, the New York department went into court seeking to place ELNY in rehabilitation. The department had not declared the company impaired or insolvent, but sought the order because the company's condition was considered hazardous to its policyholders and to the public.

The department continues to feel that the company should be able to meet all of its obligations and therefore has expressed its intention to continue to pay death benefits and payments to annuitants at full value.

However, there are risks beyond the department's control that could alter our view of the company and consequently our treatment of the benefit payments. One such risk is the actual performance of ELNY's junk bond portfolio. If that performance is much worse that the already harsh default assumptions that have been used in testing, then a reassessment would be required.

Another considerable risk is the unforeseen claims against the company, such as the one recently filed by the Internal Revenue Service. Such claims, if sustained, could invade the policyholder funds.

The department would like to stabilize the company as quickly and as efficiently as possible. To this end, it has requested the expert advice of the member companies of the New York Life Insurance Guaranty Corp.

The department has kept in place virtually all the company's employees in New York and will be acquiring such other resources as the company requires, to maintain full and efficient service to its policyholders.

In a system such as ours, where considerations of safety are balanced by considerations effecting value to the consumer, the regulator is not permitted to substitute his or her judgment for that of the management of a company.

The New York department believes it has acted aggressively and with foresight in addressing the problems of the industry, and the particular problems of ELNY.

We also note that despite those efforts, ELNY's management has brought the company to the precipice of disaster. We nevertheless believe that the department's actions over the last decade have in fact prevented the company from being insignificantly worse condition than it is today.

We further believe that drawing the general conclusion about the state of the life insurance industry's condition from current circumstances surrounding ELNY would be inappropriate.

Although the company is illustrative of many of the industry's problems over the past decade, its extraordinary appetite for a new and untested investment vehicle clearly sets it apart from the overwhelming majority of life insurance companies.

Despite the problems of the last decade, the life insurance industry as a whole is reasonably well invested and in reasonably healthy condition. While it is certainly more stressed that it has been at any time in recent history, that stress is, we believe, being addressed by both the industry and its regulators.

Our system encourages entrepreneurial innovation in the pursuit of value to the consumer. The regulator must be deft at balancing that value to the consumer with appropriate safety, realizing that the two are often on a collision course.

Given the dramatic upheaval and traumatic changes in the life insurance industry over the past decade, we at the New York Insurance Department are proud of the rapid and effective attention we have given to each problem or potential problem as it arose.

A review of our actions in such areas as junk bond regulation, financial reinsurance, and asset/liability matching, demonstrates an ability to identify potential problems and then act aggressively, often in the face of significant opposition to minimize risk to the policyholders.

We believe this provides clear demonstration of just how effective State regulation of insurance can be.

Thank you.

[The prepared statement of Mr. Curiale follows:]

PREPARED STATEMENT OF SALVATORE R. CURIALE

My name is Salvatore Curiale. I am the Superintendent of Insurance of the State of New York. Beside me is Terrence Lennon, Chief of the Department's Life Insurance Bureau. You have asked us to comment today on the condition of the life insurance industry, our actions with respect to Executive Life Insurance Co. of New York (ELNY) and what, if anything, the recent regulatory actions with respect to ELNY and its parent company Executive Life Insurance Co. of California (ELIC), portend for the life insurance industry and for its regulation. In the course of this testimony I will refer not only to actions by the New York Insurance Department but also to actions of the National Association of Insurance Commissioners (NAIC), an association of State insurance regulators in which New York is an active participant.

THE LIFE INSURANCE INDUSTRY TODAY

During the last decade the life insurance industry has undergone dramatic changes. It has evolved from a mature business with stable risk elements' and generous profit margins to a business marked by instability of risk and evaporating profit margins. This has come about through a revolution In the marketplace precipitated by the dramatic rise in interest rates in the late 1970's and early 1980's. That upward thrust in interest rates put all cash values and deposits held by life insurers, as well as future life and annuity premiums, "in play," and created a period of turmoil in the life insurance industry.

The life industry scrambled to satisfy a consumer whose transformation from saver to investor was being propelled by a pyrotechnic interest rate environment. New products were developed as the marketing emphasis shifted from selling "security" to selling, at least partially, a rate of return. For many agents, the interest "quote" and the "illustration" of potentially great returns became the primary sales tool. The public became less interested in solidity and service, seeking instead, a maximum return on its dollar.

In this environment product margins began to shrink precipitously as companies struggled to compete. This condition was exacerbated by the lack of adequate management structures and the lack of effective management systems within the industry to deal effectively with these new problems.

The typical life insurers' management structure allowed for considerable functional autonomy within the organization. For example, the investment department managed the assets without much input from either the marketing or actuarial divisions. The results of their labors were used by, but not influenced by, the other units of the company.

During the eighties this situation changed; in many companies marketing considerations became the driving force behind the interest rate quoted during the sale and, thereby, indirectly influencing the companies investment decisions. Traditionally, the reverse had been true. In addition, matching of asset and liability cash-flows took on greater significance and required an ongoing dialog between the actuarial, the marketing, and the investment personnel. From this scenario it became apparent that functionally autonomous management was no longer the best management structure for life insurers today.

Life insurers in general have invested huge sums in their data processing systems. However, most of this investment has gone into the development of policyholder and financial reporting systems, with systems that monitor corporate performance lagging far behind. Twenty years ago, when profit margins were stable and generous, this was not a problem. Today, when margins are thin at best, and can become negative with disturbing speed, it is intolerable.

Thus, at the outset of the final decade of the 20th century, an industry that has flourished in this century is now struggling to redefine itself. In addition to developing integrated management structures life insurers most also devise more effective management information systems. During the past decade many life insurance companies have seen their real capital shrink. Many are being carried by the earnings derived from older business and are not earning sufficiently on their new business to carry them into the future. The responses from life insurers to these conditions have varied. Many of them have been positive and have led to better performing companies; others have been risky and have led to regulatory actions. However, there are real signs of improvement throughout the industry. Reduction of expenses has become widespread and integrated management structures have begun to take hold. The decade of the "90's" will see a significant consolidation in the industry as the problems of the "80's" are gradually managed.

The following discussion covers the principal areas of risk to life insurers that have arisen during the last decade together with the regulatory response of the New York department and of the NAIC.

A. ASSET RISK

Some companies have sought to improve their margins by achieving higher returns from their assets, generally by assuming greater risks. Although mixing moderate amounts of well diversified higher risk assets in an insurer's portfolio can be an acceptable investment strategy, concentrations in high risk assets put the policyholders in jeopardy. For this reason the New York insurance law places aggregate caps on most types of investments that a life insurer may invest in—these include stocks, subsidiaries, and investment real estate. Even within these limits insurers have generally mixed higher risks judiciously. However, in the mid 1980's the Department saw several insurers begin to build substantial concentrations in junk bonds. Because original issue junk bonds were relatively new, the New York insurance law does not directly refer to them. However, because the department viewed concentrations in junk bonds as a substantial risk to policyholders, a regulation was promulgated in 1987 limiting future investments in these assets. This regulation was amended in February 1991 to further tighten restrictions of these types of investments.

The department is also chairing an NAIC working group that is studying junk bonds. The first proposal of this group, dealing with more appropriate disclosure of and accelerated reserving for these type of bonds, was adopted in June 1990 by the NAIC. The working group has now developed a model law that would set aggregate and individual issuer investment limits for medium and lower quality bonds. It will be proposed for adoption at the NAIC meeting this June.

The department and the NAIC continue to monitor all classes of investments and the department is, in fact, chairing another NAIC working group which is developing an asset risk reserve that will cover all classes of assets, including real estate and mortgages.

B. ASSET/LIABILITY MATCHING

Another area of critical importance to the effective management of life insurers today is the matching of assets and liabilities. The mismatching of the cash-flows generated from assets and the cash-flows required by the liabilities can provide a competitive advantage to an insurer but places the insurers policyholders at considerable risk. The department promulgated in 1986 a regulation addressing this issue and the NAIC has recently adopted a model law with substantial similarities to the New York requirements. All companies writing interest sensitive products should match their assets and liabilities whether or not required to by law.

C. REINSURANCE

A life insurance company is somewhat unique, in that, due to the conservative nature of statutory accounting, the writing of new business results in a decrease in the company's statutory capital. All expenses for new business are charged up front and earnings with corresponding increases to surplus, are expected to flow as that business matures. The new interest sensitive products created an even greater strain on the surplus of Insurers than did the previous products issued by the companies. In the early to mid-1980's a new type of surplus relief reinsurance called "financial reinsurance" was developed to artificially increase the surplus of life insurers. The reinsurer placed a block of the ceding company's business on its books but did not assume the primary risks of that business. The ceding company decreased its liabilities, thereby increasing its surplus, without having transferred the real risks of the business. The use of "financial reinsurance" seriously distorts an insurer's financial statements, and at times, masks real problems. The New York department promulgated a regulation in 1985 disallowing credit for this type of reinsurance. The department's regulation, with minor modifications, has been adopted as an NAIC model.

D. HOLDING COMPANY ABUSES

Holding company abuse of insurers is another area of risk for the industry. The failure of the Baldwin-United life companies was caused by the "milking" of life insurers by a noninsurance parent. Strong holding company laws and aggressive enforcement of those laws are essential ingredients to effective regulation of the insurance industry. New York has found that its law has been highly effective in regulating this area. The department chaired an NAIC group that amended the NAIC Model Holding Company Law to track the strong enforcement provisions of the New York statute. The amended law was adopted by the NAIC in 1986.

E. ASSAULT ON STATUTORY ACCOUNTING

Finally, in an effort to "squeeze" more capital out of the balance sheet there has been an assault on statutory insurance accounting. For the protection of policyholders, statutory accounting results in a forced conservatism in preparing an insurer's financial statement. Insurers, in a desperate effort to show more surplus, have waged a campaign to recognize all the values in the assets on their books (as well as "values" in some assets not on their books) and to reduce their liabilities below the conservative levels set by regulation.

Both the New York department and the NAIC have been very active in recent years in analyzing and ruling on a significant number of schemes to enhance surplus at the expense of statutory accounting. These have included sale and leaseback arrangements and the securitization of future revenues. We expect the assault to continue, especially by those companies that most see their profitability restored to a level at which they can attract real capital. However, both the department and the NAIC have, in their rulings, remained firm in their insistence on conservative accounting principles.

EXECUTIVE LIFE INSURANCE CO. OF NEW YORK: ITS PRICES AND NEW YORK'S REGULATORY RESPONSE

The subcommittee has requested our comments with regard to the department's request that the court place ELNY into rehabilitation. ELNY's problems touch on several of the concerns outlined above. For example, ELNY's investment strategy was a primary factor in prompting the department to promulgate its junk bond regulation in 1987. In addition, the department has, through a series of actions, caused ELNY to remove all of the "financial reinsurance" from its balance sheet. Finally, both in the report on examination filed on May 2, 1990, and in our recent actions we have indicated that the company's reserves required strengthening because of a mismatching of the cash-flows from assets and liabilities and of the low quality of the supporting assets with the need to provide for defaults. The following discussion of the department's actions with respect to ELNY are summarized under three headings: those actions related to reports on examination filed on (1) March 2, 1987, and on (2) May 2, 1990, and (3) those actions taken during 1990 and 1991.

REPORT ON EXAMINATION FILED MARCH 2, 1987

As noted above, the writing of new business results initially in a decrease in a life insurer's capital. During the course of the regular triennial examination of the company it was discovered that, in order to relieve the surplus strain caused by the large increase in annuity products being written at the time, the company had entered into numerous "financial reinsurance" agreements, principally with alien companies. A review of the treaties and of ELNY's reinsurance practices revealed a large number of .violations and a' manipulation of reinsurance transactions specifically designed to give surplus aid to ELNY while transferring little or no actual risk to the reinsurer.

The examiner's review of the reinsurance transactions included the examination, under oath, of a number of ELNY's officers. In resolution of the findings of the examination, the company and its parent including First Executive Corp. (FEC), agreed to the following in a commitment letter dated February 23, 1987:

(1) ELNY would sign a stipulation that it had committed the violations enumerated in the report on examination and that it had improperly accounted for numerous reinsurance transactions in its 1983, 1984, and 1985 annual statements. The stipulation is dated March 2, 1987.

(2) FEC and ELIC would cause an infusion to be made to the capital of ELNY in the amount of $151,500,000. The infusion represented the amount of reserve credits disallowed as a result of the examination.

(3) ELNY agreed to pay a fine of $250,000. This equal led to the largest fine ever levied by the department as of that date and remains the largest fine ever imposed against a New York life insurer.

(4) ELNY would cause its 1986 annual statement not to be signed by those officers whose testimonies were taken, and that these same officers would resign as officers and directors of ELNY by December 31, 1987.

(5) ELIC would voluntarily withdraw from New York as an accredited reinsurer by February 17, 1990. The company, in fact, withdrew on June 18, 1987.

The actions taken by the department were primarily a response to the extensive adverse findings regarding the reinsurance operations of the company and the testimonies of ELNY's officers. The department's actions left ELNY in a solvent position, provided public notice of ELNY's situation, and avoided long legal proceedings which would have resulted in uncertainty and anguish for policyholders.

REPORT ON EXAMINATION FILED MAY 2, 1990

It is the department's policy to certify to the reserves of domestic life insurers based on a review of material submitted to our Actuarial Valuation Bureau. As part of such certification process, each company is required to submit, with regard to certain annuity and life products, and in accordance with regulation 126, a demonstration that the assets held by such insurer are adequate and sufficient to meet the corresponding liabilities of the insurer. This is the regulation referred to above in the section dealing with asset and liability matching. If an insurer cannot demonstrate to the satisfaction of the superintendent that its assets are adequate to cover such liabilities as they mature the department can impose a penalty in the form of additional reserves.

The department found that ELNY's assets did not match its liabilities and issued certificates of reserve valuation to ELNY for calendar year 1986, dated February 2, 1988, which included penalty reserves of to $169,599,101. The penalties reflected an estimated $110 million in additional reserves for immediate annuities and structured settlements, and the balance for the improper reserve credit taken under the various surplus relief treaties.

At that time of the filing of the report on examination:

(1) The company had engaged an independent consulting actuary to prepare its Regulation No. 126 filings. The filings were found acceptable for 1987 and 1988 and the department certified to the reserves as shown in ELNY's 1987 and 1988 annual statements. Up through the 1988 yearend the default experience on junk bonds was rather modest.

(2) ELNY's 1988 annual statement indicated that, no reserve credit for financial reinsurance was being taken by the company.

(3) ELIC had made a contribution to the surplus of ELNY on February 27, 1990, in the amount of $50 million.

ACTIONS DURING 1990 AND 1991

By the beginning of 1990 the department's actions over the prior 5 years had the following effects on ELNY's condition:

(1) The junk bond regulation of 1987 did not require a divestiture of existing holdings since the existing portfolio was an integral part of a company's pricing assumptions. Rather the regulation did not permit additional purchases until a company was down to the limit. Prior to the regulation ELNY's concentration in junk bonds reached as high as 70 to 75 percent of assets; by the end of 1989 it had dropped to approximately 50 percent of assets.

(2) The department's actions with respect to financial reinsurance had completely eliminated the effects of the artificial surplus generated by such transactions from the company's financial statements and caused the company to refrain from entering into new ones.

(3) ELNY had received cash infusions of approximately $201 million, in the form of contributions to surplus, during the period from 1987 to early 1990.

(4) At the end of 1989 the company reported $105,202,338 in capital and surplus and $165,828,267 in a reserve required for risks in a company's securities portfolio. Therefore the company at the beginning of 1990 reported a total of $271,030,605 to protect against risks in its portfolio.

In the early stages of 1990, as defaults mounted in junk bonds, First Executive Corp. announced substantial writeoffs in the value of its total portfolio. That portfolio was held in its various insurance subsidiaries. The publicity attendant to the release of this information, coupled with worsening conditions in the junk bond market, began to concern policyholders and caused an increase in surrenders at ELNY.

In February 1990, a special NAIC group was established to monitor ELNY and ELIC. The New York department and the California department were members of that group. At that time, although surrenders continued, to mount, ELNY's liquidity (cash or securities easily converted to cash) was more than adequate to handle surrenders without incurring losses.

The California department instructed ELIC to engage an actuarial consultant to perform testing that was similar to that required by New York's regulation 126. Since this work was to be done throughout 1990 and results shared with the NAIC group, the actuarial firm, Milliman and Robertson, was instructed to perform the testing for ELNY as well as ELIC.

The testing, done as of December 1989 and again as of June 1990, showed ELNY able to continue to meet its obligations even when tested against severe assumptions for surrenders, defaults in junk bond investments, and interest rate changes. During the second half of 1990, surrenders dropped and leveled off at more acceptable levels. However, defaults continued at a very high rate prompting regulators to determine toward the end of 1990, that, for the purposes of the actuarial testing, the default assumptions should become more specific to the portfolios of each of the companies rather than using multiples of average default rates.

Therefore, Salomon Brothers, Inc. was engaged by the New York and California department's to perform security specific testing on the portfolios of ELNY and ELIC and to provide security specific projected cash-flows to Milliman and Robertson for use in the actuarial testing for the NAIC group and for New York's regulation 126 testing.

The New York department has had examiners at ELNY continuously since February 1990. These examiners, while there to perform the regular triennial examination, monitored among other things surrenders, defaults, and the company's liquidity on a continuing basis.

On March 1, 1991, as required by statute, ELNY submitted a statement of its financial condition, as of December 31, 1990, to the department. The company reported capital and surplus of $185 million and an additional $29 million in the special reserve for risks in the securities portfolio. The examiners at the company immediately pointed out the misclassification of several bonds which, when corrected, could cause losses that would eliminate the special reserve.

On Thursday, March 28, a meeting was held in the department's Albany office with the department's actuaries, ELNY's valuation actuary and ELNY's consulting actuary in order for their actuaries to present some results of some testing and to discuss the assumptions, additional scenarios and additional reserves before making a formal submission of the 1990 actuarial opinion and memorandum required by regulation 126.

Regulation 126 requires that the cash-flows demanded by the liabilities be tested under a range of assumptions including interest rate assumptions, surrender assumptions and default assumptions to verify that the cash-flows from the assets would match those demands. ELNY has a mix liabilities, some of which are demand liabilities (i.e., the contractholder has the right of surrender) and others in which there is no right of surrender and which will therefore mature over a much longer period.

The initial testing performed by the company's actuaries showed that, on a set of least acceptable assumptions for our consideration, the company needed $125 million of additional reserves. The department actuaries felt additional assumptions needed to be tested, however, they concluded that the $125 million was the minimum additional reserve necessary. A memorandum to this effect was prepared and faxed on Monday, April 1, to the bureau in the department's New York office responsible for monitoring the company's solvency. That bureau, the Life Insurance and Companies Bureau, had also just received evidence that the company was selling an annuity contract with a 9.25-percent interest guarantee for 5 years even though all new money was being invested short term at between a 6- and 7-percent return.

The Life Bureau, on Wednesday, April 3, instructed ELNY by letter, to refile its financial statement in all jurisdictions in which it was licensed, showing the additional minimum reserve of $125 million and indicating that discussions with the New York department with respect to possible additional reserves were continuing. This same letter also instructed ELNY to discontinue the writing of all new business until such time as it had demonstrated to the department that such new business was self supporting and not eroding the position of current policyholders. On April 4, the department announced these actions to the press and to all State insurance departments so that the public and the regulators would be aware of these actions as soon as possible.

On Monday April 8, a meeting was held with ELNY and its consulting actuary to discuss the assumptions to be tested for the regulation 126 opinion. The company's consulting actuary noted that the cash-flow testing techniques were designed for going concerns and are not as reliable when a company is in the midst of chaotic conditions. The same actuary also pointed out that the use of the Salomon Brothers study would be more appropriate than more speculative default assumptions. While the department recognized some merit in these points it felt that it had the responsibility to continue the testing process and therefore instructed that further assumption testing be performed and delivered to the department using assumptions designated by the department.

At this time there was almost daily press speculation that either ELIC or both companies would be taken by the regulators and surrenders had again begun to mount. In light of these events the department, at that meeting, directed the company to make no disbursements, other than payments to policyholders, beneficiaries, or annuitants, in excess of $5,000 without the prior written approval of a department representative. This was confirmed by letter the next day.

On Thursday April 11, the California Commissioner went to court to begin the process of placing ELIC into conservatorship. The press coverage of this event precipitated an avalanche of surrender requests at ELNY. By Monday April 15 crowds of policyholders were gathering at ELNY's offices.

The hemorrhaging was having a destabilizing effect on the company and had the potential of disadvantaging those contractholders without surrender rights. These surrender requests could result in nonjunk assets being liquidated thus increasing the percentage of junk bonds supporting the remaining policies. Therefore on the afternoon of April 15 the New York department went into court seeking to place ELNY in rehabilitation. The department had not declared the company impaired or insolvent, but sought the order because the company's condition was considered hazardous to its policyholders and to the public.

The department continues to feel that the company should be able to meet all of its obligations, if interest rates are stabilized at current levels and if default costs and surrenders return to normal levels, and therefore has expressed its intention to continue to pay death claims and payments to annuitants at full value. However there are risks beyond the department's control with the capacity to alter our view of the company and consequently our treatment of the benefit payments. One such risk is the actual performance of ELNY's junk bond portfolio. If that performance is much worse than the already harsh default assumptions that have been used in testing, then a reassessment would be required. Other risks are the decrease in interest rates for a prolonged period and heavy surrenders.

Another considerable risk is unforeseen claims against the company such as the one recently filed by the Internal Revenue Service. Such claims, if sustained, could invade policyholders funds.

The department would like to stabilize the company as quickly and as efficiently as possible. To this end it has requested the expert advice of the member companies of the New York Life Insurance Guarantee Fund Corp. The department has kept in place virtually all of the company's employees in New York and will be acquiring such other resources as the company requires to maintain full and efficient service to its policyholders.

EXECUTIVE LIFE'S EFFECT ON THE LIFE INSURANCE INDUSTRY

In a system such as ours, where considerations of safety are balanced by considerations effecting value to the consumer, the regulator is not permitted to substitute his or her judgment for that of the management of a company.

The New York department believes it has acted aggressively and with foresight in addressing the problems of the industry and the particular problems of ELNY. We also note that despite those efforts ELNY's management has brought the company to the precipice of disaster. We nevertheless believe that the department's actions over the last decade have, in fact, prevented the company from being in significantly worse condition than it is in today.

We further believe that drawing a general conclusion about the state of the life insurance industry condition from current circumstances surrounding ELNY would be inappropriate. Although the company is illustrative of many of the industry's problems over the past decade, its extraordinary appetite for a new and untested investment vehicle clearly sets it apart from the overwhelming majority of life insurance companies.

Despite the problems of the last decade, the life insurance industry, as a whole, is in reasonably healthy condition. While it is certainly more stressed than it has been at any time in recent history, that stress is, we believe, being addressed by both the industry and its regulators. No regulatory system in the United States, including the insurance regulatory system, is designed to prevent failure, nor should it.

Our system encourages entrepreneurial innovation in the pursuit of value to the consumer. The regulator must be deft at balancing that value to the consumer with appropriate safety, realizing that the two are often on a collision course.

Given the dramatic upheaval and traumatic changes in the life insurance industry over the past decade we at the New York insurance department are proud of the rapid and effective attention we have given to each problem or potential problem as it arose. A review of our actions in such areas as junk bond regulation, financial reinsurance and asset/liability matching demonstrate an ability to identify potential problems and then act aggressively, often in the face of significant opposition, to minimize risks to policyholders. We believe this provides clear demonstration of just how effective State regulation of insurance can be.

Senator BRYAN. Mr. Curiale, thank you very much for your testimony. In our opening round of questions, we will limit us to 5 minutes, and then we will have an additional round as necessary.

Mr. Garamendi, I think the question that hundreds of thousands of policyholders are asking themselves, what are the prospects of the face value of the policies being honored in the case of those who have life insurance policies, those that have annuities in that category of guaranteed insurance contracts. Can you give us a little bit more of your own assessment at this point about where those people stand?

Mr. GARAMENDI. I will certainly share with you my thoughts at this time. There are some big unanswered questions, particularly the IRS claim. If that claim stands and if additional claims are forthcoming from the IRS, they will simply be in the front of the line and they will take this company into liquidation. That liquidation would substantially harm the prospects of all of the policyholders, annuitants, GIC holders, and all of the people who are counting upon this company.

The activity that we are attempting to do is really, I think, new and that is to very quickly turn the company around, to rehabilitate it. That has not been the normal pattern when a company is in trouble, but it is one that we are attempting to use.

We have entered into negotiations with a French concern, a consortium, lead by Altus, a subsidiary of Credit Lyonnais. We expect other consortiums of investors to be formed and to also bid on the company. We expect this to be done in a very short timeframe.

If we are successful in those negotiations in restructuring the company, the policyholders should be as well off as they could possibly be under the circumstances. We want to avoid a liquidation. A liquidation of this particular company would, in our view, be a disaster for the policyholders.

The nature of the assets, the heavy load of junk bonds, much of which has no market value or has no market but some value, raises a big question in our mind if we ever have to move to liquidation.

I cannot at this time give an estimate of what the ultimate outcome will be for the policyholders. There are just too many unanswered and unknown factors, particularly on the asset side.

I would expect that there will be a restructuring of the liabilities. That is, of the value of the contracts, the policies that are outstanding. It is my goal to do the very best possible for the policyholders, obviously that would be to honor each and every contract.

That is what we want to accomplish. At this time, we do not know what we will be able to deliver.

Senator BRYAN. Mr. Garamendi, I take it that if the negotiations with Credit Lyonnais come to fruition that it would be your hope that all of the policyholders, including the guarantee insurance contract holders, would be made whole. Is that the hope?

Mr. GARAMENDI. Well, let me use a different word than "hope." Let me use the word "goal."

Senator BRYAN. Goal.

Mr. GARAMENDI. Our goal in conserving the company was to protect the policyholders and all contractholders, annuitants, and GIC holders, to the maximum extent possible. The testimony provided by Mr. Curiale and myself as well as Mr. Metzenbaum today clearly should tell the world that this company is in deep trouble.

The heavy reliance on junk bonds creates tremendous uncertainty as to what can be accomplished for the policyholders. It is unlikely that the full contract value of the GIC's and even of the policyholders will be met in the rehabilitation plan.

Senator BRYAN. Under the present terms of the conservatorship, as we are led to believe, you are currently paying the face value of life insurance claims, the ordinary life policies, 70 percent of the annuity claims, and none of the GIC's at the present time. Am I correct on that?

Mr. GARAMENDI. That is correct. The reasons for that are that that is the minimum level we believe the company can meet under the most adverse of circumstances.

With regard to the GIC's, there is a substantial legal question as to their ranking in the priorities under the laws of the State of California. This company created many new products that were not known and not contemplated by the laws and by court action to date.

The GIC's fall within that area and therefore we chose at the outset not to make payments on the GIC's. As to what will ultimately transpire as to their payment and prioritization, that is a question that is open at this time. It will be answered as we move through the rehabilitation process and the resultant court orders that will come of it.

One thing I would like to add. In the rehabilitation of this company and the plan that we are developing with Altus or any other potential investor, we will capture the up-side potential in the assets. Since there is no market price for a large portion of the assets today, we think it necessary to structure our rehabilitation plan in such a way that future increases in value, some share of the future increase in value, will flow to the policyholders and contractees of the company.

Senator BRYAN. Mr. Curiale, why do you not give us an update as to the status of your policyholders with Executive Life of New York? What payments are currently being made and which categories are not being paid?

Mr. CURIALE. We are currently paying all categories of payments. We are paying annuity benefits at 100 percent. We are paying death claims at 100 percent, pension benefits. We have a few GIC's, only three I think, in the company, and we are paying those also.

Our company, I think, is in a bit better financial condition than the California company, thanks in large part to the steps that Mr. Lennon has taken over the last 10 years with regard to the company. But it is a fluid situation, and, of course, the liabilities of this company go out many, many, many years.

With a 60-percent portfolio in junk bonds, there are so many variables: Interest rate assumptions on reinvestment of assets; whether or not the default rates, which are currently about 30 percent, will go up; whether or not—should surrenders be allowed once again; whether or not they will be a drain on the company's assets that way. All these things create a range of possibilities.

Right now, however, we are very optimistic that under many of those assumptions we will be able to pay off all the obligations of this company.

Senator BRYAN. I note that my red light has flashed. Let me yield now to Senator Exon for questions.

Senator EXON. Mr. Chairman, thank you very much. Gentlemen, thank you for being here today.

Mr. Garamendi, I could not tell from your statement. Are you in support of some type of Federal takeover of the regulation of the insurance industry as a whole, and particularly in regard to the life insurance industry?

Mr. GARAMENDI. Senator, I am quite new at the regulation business. My responsibility is to do the very best that I can with the State of California and the tools that I have available to me. We are utilizing those tools in new and far more aggressive ways.

Among those tools are the National Association of Insurance Commissioners, the NAIC, and their efforts. We note, as I mentioned in my testimony, a significant move by the NAIC to enhance the regulatory posture and position of all of the States. We think that is very important.

We are aware the NAIC is publishing new standards which have yet to be adopted by my own State, and many other States are in the process of adopting those new standards. We think that is important.

We also note the record of the Federal Government in its regulatory posture and activities in savings and loans and banks, giving us some concern about the success at the Federal level.

If, after using all of the tools and my own strong desire to exert a firm regulatory hand, I find that we are unable to deal with the multistate and international nature of this business, I will come back before you and request Federal assistance and Federal regulation. I am not yet at that point.

Senator EXON. Let me ask the question a little bit different way, then, so I can get a more definitive answer.

Is it fair to assume then for the present session of the Congress, you do not feel that we should pass any type of a law that would institute Federal regulation?

Mr. GARAMENDI. I believe that there has to be a national standard that is used in each State in the regulatory processes of that State. That standard is now being set forth by the NAIC.

Should States utilize that standard, put it into their laws and into their regulatory practice, there would be no need for a Federal law. However if, for example, my State refuses to pass such a law, then I would suggest there is a major hole that would have to be filled or covered by a national statute.

Now, we are in the process now of pushing legislation in the California Legislature that would adopt the NAIC standards. Hopefully, my State legislature and Governor will approve such a bill.

Senator EXON. My time is limited and I am trying to get some answers from you that are a little more definite than you have given.

Mr. GARAMENDI. You want me to tell you——

Senator EXON. What you are telling me then, I guess Mr. Garamendi, if I can paraphrase you without putting words in your mouth, you are saying that as far as your responsibility in California is concerned, unless you can get through some regulatory reform through your legislature and signed by your Governor, then you would think that the only alternative might be Federal regulation. But you are not in support of Federal regulation at this time, is that a fair statement?

Mr. GARAMENDI. Mr. Exon, I have long ago learned not to tell a Senator how to vote, but let me tell you that that is a fair statement.

Senator EXON. Thank you. Same question of you, Mr. Curiale.

Mr. CURIALE. Senator, we are in favor in New York of good insurance regulation, effective insurance regulation, and I think we have demonstrated through 125 years that that is the type of regulation that we have.

On this subject, I am from Missouri. I would like to see some sort of a scheme or definite framework proposed of Federal regulation that would be an improvement on what we have now. Until somebody shows me something which is fleshed out, I am in favor of what we have.

Senator EXON. Let me ask both of you this question. How much, in your opinion as experts in this area, are the accounting firms and the rating firms and their failures responsible for the serious matter that confronts us today, especially with this one company and very probably others?

Mr. GARAMENDI. Earlier testimony today indicated the problems that exist with the accounting firm at Executive Life. It is a major problem. It is one that I will comment on very cautiously because of a series of lawsuits that are inevitable. And so, let me say that the testimony provided, I think, lays out the basic problem.

There is beyond that a problem that exists in that it is a very incestuous and tight industry. The insurance industry, the accountants, and the rating firms are all very, very close and seem to depend upon each other.

We have very serious concerns about that whole process. We think that it needs a great deal of scrutiny and a whole lot more openness. We think that there is some real—that the public has a lot to be concerned about when they put their trust in accounting firms and in rating firms.

Beyond that there are, in my mind, some very serious questions as to the way in which accountants account for the assets. Mr. Curiale mentioned the New York system which, in my view, is a far better system than we have utilized in California. We are moving toward their system, but even then I suspect that there are shortcomings in what New York does.

Senator EXON. Well, my time is up.

Mr. Chairman, just let me say that it seems to me that when we have difficulties like this every one says what is the Government going to do about it? The Government has a responsibility that we are addressing, I think, and will discharge in some fashion. Whether it is a good fashion or a bad fashion, remains to be seen, but likewise with my comments that I have been making for many years.

In fact, in criticism of the State regulators and your association, you seem to be waking up even if belatedly to the fact you have got to do something better than you did in the past, and I am going to take a very close look at that.

I also would say that professions, professions like the accounting profession, and if there is such a thing with rating firms and that profession, have fallen down on the job also. Because when you are in a profession, you have certain standards to set and you have some in-house policing to do, which I am fearful has not been done very well in the accounting profession. But that remains to be seen, and that is an editorial comment.

Thank you very much, Mr. Chairman. Thank you, gentlemen.

Senator BRYAN. Thank you, Senator Exon. Senator Ford.

Senator FORD. Mr. Garamendi, are you the only elected Insurance Commissioner in the country?

Mr. GARAMENDI. I believe there are 12 who are elected.

Senator FORD. When you became the elected Insurance Commissioner of California, when you took office, did you bring any new laws with you, or are you operating under the laws of California without any change?

Mr. GARAMENDI. As of today, we are operating under the laws of California as they exist. The legislature is now in session, and they are working on several changes to the laws.

Senator FORD. But when you came into office, you were operating and doing what you were doing based on the California laws that were in place. You did not bring any new laws with you?

Mr. GARAMENDI. That is correct.

Senator FORD. That says something about the Commissioner, too, does it not?

Mr. GARAMENDI. I know that I have a far different attitude about my job than previous Commissioners.

Senator FORD. Let me ask you this question: Is there a chance the IRS claim will be valid?

Mr. GARAMENDI. There is a chance. I have yet to meet an IRS agent who did not believe their position to be correct. [Laughter.]

Senator FORD. Yes, but if you talk to the next one, his opinion is different.

Mr. GARAMENDI. Well, let me tell you that our opinion is far different than the IRS. We think that their claim is without merit, and we intend to pursue that. We know that if the IRS claim stands and the penalties stand and there are any future year claims, this game is over. It is an end game move, and it will simply kill any effort that we have to rehabilitate this company.

Senator FORD. That sounds typical of the Federal Government and their regulatory agencies.

What was the rating, either one of you—Mr. Curiale, what was the rating of this company up until the last year or so?

Mr. CURIALE. Terry, do you know?

Senator FORD. Would Standard & Poors be the basic——

Mr. LENNON. Standard & Poors rated the New York company. At least, I am not familiar with—I am sorry, the rating was actually of the California company, not of the New York. We were some of the California company, and it was AA up until, I believe, sometime in 1989, and frankly that reflected an attitude that existed in the country about what was going on in the 1980's, and it is difficult.

We viewed the company during that period of time as having substantial risk, as seen by the 1987 junk bond reg that we proposed. We had a lot of difficulty in getting that regulation put in place. We were called to a hearing in Washington, we were called to a hearing in Albany, and in both places we were told that junk bonds were wonderful things, and they were providing jobs, and that we had no business doing this.

I think that that environment is what led Standard & Poors and Moody's and the others to think that junk bonds were something other than the risk that they were.

Senator FORD. So, you are telling me that Standard & Poors makes a judgment on the financial stability of a company based on a mood, rather than on a fact?

Mr. LENNON. Well, I think based on a vision of the financial structures of the company.

Senator FORD. So, now they are having visions? [Laughter.]

Mr. **LENNON**. Oh, I would not defend them.

Senator **FORD**. I am not trying to be funny here, but if I, as a purchaser, would go look at Standard & Poors and I would find this company AA-rated, that would influence my judgment a little bit. Somehow or another, it seems that there ought to be a better criteria somewhere along the way, as it relates.

Now, New York has always been a leader in the insurance industry, and they were always a little further ahead, or a little nearer the edge of new and innovative ideas. The NAIC rules that they have put out, how close will that come to helping us on a national basis? Now, that is to have a CPA do the audit on the books. That is one of them that has not been done. I cannot imagine anybody not doing that, but nevertheless that is so.

Mr. **GARAMENDI**. Well, you may not imagine it, but in fact many of the audits are not certified. Certainly the audits ought to be certified, and certainly the auditing firm ought to be on the hook.

Senator **FORD**. Can you put that firm on the hook with State law?

Mr. **GARAMENDI**. Yes.

Senator **FORD**. And NAIC, will that put the firm—that, then, would have a CPA firm certify it and then that puts them on the hook?

Mr. **GARAMENDI**. The NAIC rules are suggestions. It is the States that must carry them out, and the NAIC does not make the law. It is the State. In our State, I have some powers and I am certainly going to be requiring that the audits be certified, that the accounting firm be on the hook.

I think there is one that we ought to go back to, what Terry said a moment ago, and that is the attitude of the 1980's was go, go—anything goes—and to deregulate.

Certainly the Department of Insurance in California reflected that attitude and did not use a firm regulatory hand in overseeing insurance companies in the State, and Executive Life will, I suspect, be the principal example of that.

When it was clear that there were problems the State took the least action, not the strongest action. That has changed, and I will not do it that way.

Mr. **CURIALE**. Senator, along the lines of your question about the statutes, the statutes and the rules and regulations are just part of the story. A bigger part of the story is the development of staff.

In New York, we are fortunate to have people like Mr. Lennon, who is a 25-year veteran, and others—many others like him, 25, 35, 40 years even—at the department. It is that which makes a department effective, and of course the statutes, rules and regulations are a step in the right direction, but you do need more, and I think the NAIC and the States do recognize that fact.

The junk bond regulation that New York implemented in 1987 is a prime example of that. Around 1986 we had a few people in our life bureau who were getting very nervous about junk bonds, even though they were flying high at the time.

They had been around for quite some time, and had seen other types of innovative financial gimmicks. I would not call it a gimmick, because that is really to pejorative, but financial instruments that had not gone through a full cycle. That is what made our people nervous, and that is what made them start to tinker and come up with a regulation that they thought would be more prudent.

As Mr. Lennon said, I think, we had to fight to get that regulation through. Our own legislature came at us fang and claw. Drexel Burnham went to the Governor, they went to Washington. It is through the foresight and, I think, the intestinal fortitude of Governor Cuomo and ultimately the legislature that we were enabled to get that regulation through.

Senator FORD. Would this company have purchased any local bond issues—sewer, water, things of that nature? Would they have that in their portfolio?

Mr. LENNON. The New York company has none of the so-called municipal GIC's in it at all.

Senator FORD. What GIC's are there? How could local entities—do you see what I am driving at? This may be a rippling effect which will wind up in a wave on some small community that this company would have purchased its bonds from, and that sort of thing.

Mr. LENNON. Do you mean its general investments? The New York company, and I would believe the California company, did not invest in municipal bonds, as such. I thought you were referring to the GIC's.

Mr. GARAMENDI. We do not have municipal bonds, as such, in the portfolio. There are the guaranteed investment contracts. We call them muny GIC's which were testified to earlier in, I think, Senator Bryan's testimony.

Mr. BAUM. Senator, the issue is not so much of the purchase in the Executive Life portfolio of municipal bonds, but rather the creation of products that Executive Life sold. One set of those products is GIC's, or guaranteed investment contracts that were used to support municipal bonds, and there are a variety of those out there.

Senator FORD. That is my connection. I was trying to put the two together, and somehow I got the connection that it would do that.

I see my caution has gone to red, Mr. Chairman. Just a final question, please.

In looking at this—insured failure small in comparison to the depository institutions and other things—on balance has the insurance industry had a lot of insolvencies, bankruptcy?

I know when I was Governor, and probably my two colleagues here, when they were Governors, we had to do lots of things. We took over and rehabilitated life insurance companies and gave them back to the people and they are now going concerns, and State-chartered savings and loans, which I changed to federally insured, got 98 cents back on the dollar. We worked hard at those sorts of things, but it was a local effort and Federal regulations did not involve too much.

But what about the insolvencies of the insurance industry as such? It shows where the black line [indicating] is in commercial banks now, and the dotted line is savings and loans, but right down here, almost even with the board, are insurance companies. That says something for State control, in my opinion.

Mr. CURIALE. I agree with you, Senator. I think that by and large, in a competitive society as we have, where we insist on balancing value to the consumer with the financial solidity of the company, you are going to have some failures. It is inevitable.

But I think that the record of the States and of the insurance industry is quite laudable. I think that we have shown that we have had a good handle on regulation, and I might say that I think, at least in New York, the Executive Life of New York situation will prove to be a demonstration of how effective State regulation works.

Senator FORD. I could attest to that from past experience.

Mr. GARAMENDI. I must take a different view. While New York has been a leader, and their action with ELNY is far different, and far more proactive and protective of the public, the California department of insurance in the previous administration did not act in a way that would provide the level of assurance necessary for the policyholders in the State of California and across the Nation.

There were several examples, all of which have been mentioned in testimony earlier, where this department either overlooked or did not take action when there were signs and symptoms of a problem.

Executive Life is the first company. We are monitoring other companies, and hopefully this problem will not escalate and move from a straight line at the bottom of your chart to something quite different.

Senator FORD. When you say, you are monitoring other companies, are those California-organized companies?

Mr. GARAMENDI. My responsibility lies with those companies that are organized and domiciled in the State of California. My concern goes to companies that operate in the State of California that may be domiciled in other States or other nations, and there are problems beyond life insurance companies that we see daily in California. Some are domestic California companies, others are international or in other States. It is a constant piece of work for us.

Senator FORD. There were statements by people in this hearing, and picked up by the news, when they say major insurance companies are basically on the edge of going bankrupt, and that sort of thing. It puts a run on them, and probably will cause it to be.

I do not know how bad off the Traveler's might be, but it has always been a symbol of a strong company in my view, and to hear this morning that it is on the verge of insolvency, or in real trouble, by one of the witnesses makes me feel a little uneasy based on what might happen tomorrow, or this afternoon, when we know that you might have taken it over and put it back together, and if that statement had not been made you probably would not have to. So we have to be very careful.

Thank you, Mr. Chairman. I am sorry to take so long, but this is an interesting panel, and I thank both of you gentlemen and your colleagues for coming here today. You have been very important to us.

Senator BRYAN. Thank you, Senator Ford.

Mr. Curiale, you in your oral testimony made the statement that the regulator is not permitted to substitute his or her judgment for that of the management of the company. I must say that for many of us that is a very difficult statement to accept, because the role of the regulator, as many of us perceive it, would be to do just the opposite, to exercise his or her judgment independent of what the management of the company would do.

Yet it would seem to me that one of the hallmarks of investment prudence would be to have a diversity in the portfolio, whether we are talking about one's individual and personal investment strategy, certainly with respect to a portfolio of a company which can affect many thousands of people.

Now, this company prior to 1987 in New York had something like a 70-percent holding in junk bonds, although you did take action which you have described to reduce that. As I understand it, that only operated prospectively. That only said, with respect to future acquisitions. It did not address retrospectively what their holding would be.

Can you square that with the concerns which you and Mr. Lennon have shared that you were having some real qualms by 1986 that this junk bond business was not all of the vision and the hopes of the 1980's go-go philosophy?

Mr. CURIALE. Senator, there are parameters in terms of where the State steps in, when it steps in to say that you have exercised enough business judgment up to this point, but now you are putting the policyholders in danger.

But I would rather have Mr. Lennon, who lived this over the last 10 years, talk about that.

Senator BRYAN. Sure.

Mr. LENNON. I think, Senator, that you find that we have to operate within the constraints of the legislation that we are provided with, and the rules and regulations that are legitimately drawn from that legislation.

In point of fact, the biggest jump—at the time we resolved to write either a law or a regulation to stop it, the company was at about 38 percent junk bonds. It literally took us that long of meeting brick walls and meeting with lots of people to try and refashion language, and ultimately, finally issuing this thing in the face of, I guess, editorials in many of the major press, criticism from legislatures, and a threat of a suit from Executive Life. That is what we were faced with when we issued it.

Our basic thing there was trying, perhaps, to take a management step because we felt that this was an extraordinary risk. Our regulation was issued on the strength of that we were interpreting what "prudent person" was.

That was the link to legislation and probably the link that would have been attacked had they brought the case to litigation against us, but it is very difficult once the entire world—and as we have said, the rating agencies were almost uniform in thinking that these companies were not at great risk. We had a kind of isolated opinion at that time.

It is not easy. We are not permitted to—and probably correctly, because if we could substitute our judgment for management judgment all the time you would have pretty much vanilla companies all over the place with probably not a lot of value to consumers, because we tend to be a conservative lot.

There are certain returns to letting management be innovators. It goes on all the time, and it does not always bring a company to this kind of an end.

Senator BRYAN. Mr. Lennon, let me be clear that you were seeking legislation from the New York Legislature. Am I incorrect in assuming that your legislative authorization, as an executive agency, is so limited that without that legislation you could not, on your own, take whatever steps you felt were prudent and necessary to protect?

Mr. LENNON. No, in that instance we could not. The law in New York had a number—and I will go over them with you. There were a number of very specific investment guidelines in the law, but at the time the law was drafted original issue junk bonds did not exist, and it was silent.

Senator BRYAN. My concern is that we have seen an extraordinary creativity in the types of new investments. The hybrids, the ingenuity, is unlimited. Now, if indeed the regulatory structure always has to follow the creation of these new instruments, you and your fellow Commissioners and your staffs are going to be hopelessly behind the power curve.

Do you not have, or have you not requested legislation that, without specifically defining the type of investment instrument, could give you a rather broad latitude of authority to say, look—if you believe that a course of action is being taken, namely an investment in some kind of instrument that is not even on the market today but may come on the market in the next year or so, if this creates a risk in terms of the solvency of the company and thousands of policyholders I am somewhat incredulous that you would be unable because of statutory constraints to take the appropriate course of action.

Mr. CURIALE. Senator, I am very doubtful that we would have the ability to get such a law through our own legislature, and I am doubtful that you could get such a law through the Congress that would place in a regulatory agency that kind of discretion.

Personally, as a superintendent of insurance, I say, why not? But frankly, my colleagues or, not my colleagues but my superiors, in terms of their being elected by the people in Albany, and I would venture to say in Washington, I think would have a hard time giving that kind of power to me.

Mr. GARAMENDI. Senator, if I might provide a California perspective?

Senator BRYAN. Yes, Commissioner.

Mr. GARAMENDI. I agree that it would be very difficult to get a law through the legislature. In fact, a law similar to the New York regulation was attempted last year in the California Legislature and summarily killed in the first hearing of the assembly. It is being attempted again this year.

We think, however, that under the powers that I am given as Insurance Commissioner to protect the policyholders, that we can intervene in a company's operations if they are operating in a manner hazardous to the well-being of the policyholders. We intend to use that broad power to force the companies to justify the investments and we want to try to change our regulatory scheme to one that would force the insurance industry to justify its overall investment strategy and, as New York presently does, match that investment strategy with the liabilities.

Senator **BRYAN**. Well, I would commend you for that aggressive interpretation and the actions that you have taken since you have assumed the office of Insurance Commissioner.

You talked about the NAIC, Mr. Curiale, and as we all know that is an association which, by reason of its standards, its operating procedures and rules, does not have the force of law. Some States may choose to adopt the national standards. Others may not. Would you favor Federal legislation to establish national standards patterned along what the NAIC would recommend?

Mr. **CURIALE**. Senator, I would not say that I would favor that at this point. I would say the NAIC is making a yeoman effort to make standards throughout the States more uniform. They have a certification program now which is very ambitious and I think could be quite effective. There are some sanctions being built into that certification program which would state that it if a particular State did not have its operations—its statutory basis and its regulatory basis certified by a certain year—I believe it is 1994, then any companies domesticated in that State, their annual statements could be refused by other certified States which would force I think companies to redomesticate to other certified States, and thereby, induce States to get their acts together.

I think that that has great potential for working. I am not sure that it will. And I am not ready to say that something that the Congress can come up with in terms of involvement in insurance regulation would be useless. I would just like to see more. I would like to see something which is more definitive than guidelines that would work or have the chance of working.

What I have seen from the NAIC is a program that does have the chance of working, and I think that in terms of the taxpayers' involvement—potential taxpayers' involvement—and the commitment that the States are showing, it should be given a chance.

Mr. **GARAMENDI**. Senator, might I add something?

Senator **BRYAN**. Yes.

Mr. **GARAMENDI**. I spoke earlier about this and I do not want to repeat it but to make a point. Federal—nationwide standards are essential. Whether they come from the NAIC or a Federal law, they must be there. However, in drafting Federal laws, I think you should be very careful to observe the problems that we now see in California and I suspect in New York and other States, with the ERISA laws. There is a Federal preemption that has taken place in that area and has given a tremendous concern to us in California, in what are known as MET's, multiple employer trusts, and MIWA's. It is creating serious regulatory problems, and I would urge you to be very cautious if there is to be a Federal law, so that we do not wind up with these huge loopholes through which hundreds, indeed thousands, of people are being harmed each and every day.

Mr. **CURIALE**. Senator, I would like to make one other point. This is more in a line of the general overall fears that a State regulator has when the Federal Government gets involved. I am hearing right now—I am reading in the paper, for example, of proposals to bifurcate the insurance regulation. Perhaps to give commercial carriers a Federal license, carriers that deal with sophisticated policyholders—so-called sophisticated policyholders—let them get a Federal license and leave the smaller companies to the States.

I submit that what that might do is dilute the power that the States have to look over the entire insurance industry. And I think that we have learned lessons about dual regulation in banking and savings and loan which have been very difficult lessons over the past years. And so, again, without seeing specifics and definite outlines of proposals that have a chance of working, I just throw that out as a general fear.

Senator BRYAN. Let me yield now to Senator Exon.

Senator EXON. Mr. Chairman, thank you very much. I just have one last question. I am going to read very briefly from an article that appeared in mid-April in the Los Angeles Times and get your reaction to this as two regulators as to whether you knew about it and what if anything could have been done at that time, you know, hindsight being better than foresight. But I simply call your attention to this, Mr. Chairman, and the other witnesses, because I might ask the other witnesses this question as well.

I quote now from the story:

> Top officers of the First Executive Corp. reaped windfall profits only months before the California regulators took over the company's biggest subsidiary, Executive Life Insurance Co. of California, according to an annual financial statement filed by the company.

I go on to quote:

> Five months before Executive Life was seized by the California Insurance Department, four of First Executive's top officers cashed out of a limited partnership called Executive Life Associated, Limited, which had invested in First Executive's headquarters building in Los Angeles over the past several years. First Executive Chairman, Fred Carr, earned a net profit of $1.2 million on his investment of less than $1.5 million, according to the company.

Did either one—you were not in office then, Mr. Garamendi. You were, Mr. Curiale. Did you know of this? Was there any way you could have stepped in as the top enforcer to stop this? And then I would like to have you follow up, Mr. Garamendi, with any statement on this with regard to what your predecessor did or did not do in California.

Mr. CURIALE. I would just like to say that they did not get any money out of our company, and if they try, they are going to have to sue us for it.

Senator EXON. They did not get any money out of your company in New York?

Mr. CURIALE. Of the New York company.

Senator EXON. In New York.

Mr. LENNON. As I understand it, that transaction took place at the holding company level, and let me describe to you our holding company statute. Our holding company statute is aimed at walling off the insurance company from any adverse effects or anything from the parent and its holding company. Those are separate companies those officers held titles in. And we had no rights with respect to prohibiting transactions that did not cross the boundary between the insurance company and the holding company. Those, as I understand it, had to do with the holding company, First Executive Corp., which owned insurance companies. But none of that money came from the insurance companies—at least not from the New York company.

Senator EXON. But does that not bring up another problem? It seems to me we are going to have regulation of the insurance industry and proper supervision, we have got to have authority for the regulator to look in, not only the insurance companies themselves, but the holding companies that might own them. Is that right?

Mr. LENNON. We have the right to examine the holding companies to the extent that we can look at transactions that directly impact the insurance companies. If they have other operations that have no relationship to the insurance operations, the law, as it is currently constituted——

Senator EXON. But that would not have been the case here under the circumstances of Executive Life, would it?

Mr. LENNON. I believe it would. In this case it sounds like—although I am not familiar with it, because it was not in New York and it did not impact us—that at the holding company level there was a partnership which owned the building that First Executive was housed in. That is the description that I thought I heard you give. Now, that would be remote from the New York company. There would be no relationship. We were not renting space from them. We were not involved at all.

Senator EXON. Mr. Garamendi, I am sure you are familiar with this.

Mr. GARAMENDI. Senator, we are now involved in an extensive review and investigation of the past activities of the corporation, the Executive Life, as well as the holding company, and we are investigating that transaction and a host of others. I have said before—I will say it here—that we intend to pursue every nickel that was inappropriately taken out of the pockets of the policyholders. And we will go to hell and back to get it.

Senator EXON. In view of the statement that was made by the New York officials here, was this something in your view that the insurance—then-insurance commissioner of California could have prevented under California laws?

Mr. BAUM. What the insurance regulatory scheme in California permits and generally throughout the country is scrutiny and close scrutiny of the relationship between the insurance subsidiary and the parent. So, for example, you can through directive very closely screen any upstreaming of money. You can closely screen any encumbrances that are placed by the part onto the insurance subsidiary. And I think a lot of what we are talking about here in terms of the regulatory mechanism with respect to the law may well be as much a matter of regulatory intent, incentive——

Senator EXON. Discretion.

Mr. BAUM [continuing]. Discretion, and leadership. There is another word I think is an important one and that is "attitude." And the notion of regulation as the Commissioner in California now sees it and has exerted it-is one of responsibility. And I think the issue that you asked—someone asked earlier with respect to the introduction of the Commissioner into the management of a company, there is a distinction between usurping managerial authority and holding management accountable. And it is that accountability that relates to all these issues as to your role and the Commissioner's role in guarding and protecting policyholder rights.

Recognizing that responsibility, you can hold management accountable and you can make very sure that where there is reason to enter the fray, you can control that company.

Senator EXON. Gentlemen, thank you very much. This has been very informative and very helpful to me and I think to the committee. Thanks for coming here.

By necessity I must leave. I will be back as soon as I can to question the succeeding panel. Thank you.

Senator BRYAN. Thank you very much, Senator Exon.

Let me just say that I have approached the regulation of insurance from the prospective of my own background as having been involved in State government. I must say to you, gentlemen, that the regulatory history as it exists with respect to Executive Life is not something that inspires great confidence in State regulatory system. Something fundamentally went wrong. In some instances it appears—and Commissioner Garamendi, you have testified as to the lack of aggressive implementation by your predecessor prior to your taking office, but there seems to have been a pervasive lack of aggressiveness on the part of regulators to call these problems to the attention of the unsuspecting purchaser of insurance.

The rating agencies—up to and including January 1990, A.M. Best gives an A-plus rating to this company. Standard & Poors gives it highest rating of a triple A. Now, they evaluated hundreds and hundreds of companies. They assigned some C-minus ratings in the case of A.M. Best. Some were rated by Standard & Poors as far below the triple A. Audit reports are issued which appear to give these companies a clean bill of health.

Now, this is a situation that cannot be permitted to repeat itself. So, we would certainly welcome your comments. We are going to leave the time open for some questions that we will write for other members of the committee who could not appear here today. And we would welcome your suggestion and comments, but we need frankly to hear from you in terms of what can be done from your point of view to prevent a recurrence of this. There are literally 300,000 people that could be affected by this failure. And First Capital, according to the financial journals, may be in similar difficulties and perhaps others as well. So, we would appreciate your comments, because this situation just cannot be permitted to repeat itself.

And I thank you, Commissioner Garamendi, and you, Mr. Curiale, your staffs, for being here this morning. We appreciate your testimony.

Our next panel will consist of Mr. William H. McCartney, the vice president of National Association of Insurance Commissioners, and himself the Insurance Commissioner from the State of Nebraska, and Mr. Martin P. Weiss, the president of Weiss Research.

Mr. McCartney, we will begin with you, sir.

STATEMENT OF WILLIAM H. McCARTNEY, VICE PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, LINCOLN, NEBRASKA

Mr. McCARTNEY. Thank you, Mr. Chairman, members of the committee. My name is Bill McCartney, and I am the vice president of the National Association of Insurance Commissioners and the Director of Insurance for the State of Nebraska.

Thank you for the opportunity to appear before this committee for the second time this year to talk about insurance solvency regulation. At the conclusion of my previous testimony, Mr. Chairman, you indicated that it appeared the NAIC was taking great steps to improve the effectiveness of insurance solvency regulation.

Nonetheless, you stated that if subsequent events indicated there might be solvency problems, you would hold our feet to the fire. Mr. Chairman, I can tell you that my feet are very warm today.

Since you have heard from my colleagues from California and New York, I will not add anything to their discussion about the current or projected condition of their companies. Rather, I will focus my testimony today on the subject of how State regulators through the NAIC have coordinated regulatory actions with respect to the Executive Life Insurance Co. and how that effort fits in with the broader efforts by State regulators to regulate the business of insurance in a coordinated manner.

In late January and early February 1990, a working group of the NAIC was established for the specific purpose of coordinating the efforts of those States most affected by the developing financial troubles of the Executive Life Co. The working group arose out of a recognition that without the existence of a formal framework for cooperation, State regulators concerned about the companies might, with justification, begin to take regulatory actions which could threaten the companies with avoidable calamity.

From the beginning, the working group played an integral role in facilitating the flow of information from the California and New York insurance departments to regulators around the country.

For example, in late February 1990 the California department sent an examiner to the Executive Life Insurance Co. to review the company's records. The department notified the working group of the progress of the examination, and the group met in Chicago on February 27, 1990, to discuss the examination and other aspects of the company's condition. The next day, the minutes of that meeting were sent to every insurance department in the country via the NAIC's national electronic mail system.

The working group met again on March 8 in Los Angeles to develop a specific plan of action regarding the Executive Life companies. Then from late March 1990 on, ELIC provided the working group with weekly surrender reports, including requests and payouts by product per day, bimonthly reports of operational activity including premiums and payments, and monthly reports which provided extensive detail of investment transactions and cash-flows. In addition, other information addressing specific concerns of the working group were provided on a monthly or an as-needed basis.

Over the next year, the group met either in person or via conference telephone call another 10 times, working with the California and New York departments to flesh out the body of information regulators needed in order to best protect the hundreds of thousands of Executive Life policyholders across the Nation.

The full array of available analytical tools were brought to bear on this process, including detailed financial analyses of ELIC's long-term financial viability by the actuarial consulting firm of Milliman and Robertson, a report by the NAIC's Securities Valuation Office of ELIC's nonamortizable securities and a variety of independent analyses by State regulators from across the Nation.

In January 1991, Salomon Brothers was retained to provide a detailed evaluation of the assets in ELIC's portfolio in order to give regulators a clearer picture of the company's strengths and weaknesses, and of further action needed to protect policyholders.

Certainly at this point in the process, regulators considered Executive Life companies to be in financial difficulty. Nonetheless, all indications were that, barring some shock external to the normal operations of the companies, the interests of the policyholders of the companies could be protected without resorting to conservatorship or receivership. As we have seen, however, the public release of the companies' filings with the SEC in late March of this year damaged policyholder confidence to such a degree that policy surrenders accelerated their pace, causing the insurance equivalent of a run on the bank.

The regulatory actions taken last month by the California and New York insurance departments were, in my view, an appropriate regulatory response to protect the policyholders from the potential damage of this run on the companies.

With the two regulatory actions came a sudden surge in the need for a new, higher level of communications among State regulators. The NAIC's spring zone meeting, which was held the same week as the two States' court actions, served as an excellent vehicle for the development of this elevated degree of interstate communication. Not only were the NAIC members thoroughly briefed by Commissioner Garamendi and Superintendent Curiale, but a wide range of meetings among the assembled regulators facilitated that communication.

Because all this regulatory cooperation did not obviate the need for the California and New York departments to take over the operations of the Executive Life companies, it might be asked what good it has done. In a competitive economy, there will always be companies that have financial troubles. The cost to the consumer of a regulatory system that absolutely prohibited insolvency would be unacceptable. The most one can ask of a regulatory system is that it spots troubles early, develops a maximum amount of information upon which regulatory responses may be based, and functions in a coherent, organized manner to maximize the protection available to insurance consumers under the law.

With that in mind, the 16 months of special effort in connection with the surveillance of these companies has been quite valuable in several respects. State regulators and the NAIC have marshalled a wealth of valuable information about these companies which will be vital as we sort through the variety of options before us.

Furthermore, we have developed and refined the formal and informal linkages among regulators that will be so important as each of us grapples with the substantial challenge of keeping the Executive Life policyholders in our respective states informed and protected from loss.

During the past 120 years, the NAIC has coordinated the solvency regulatory activities of the various States in a variety of ways. Through the creation of the uniform system of financial reporting, a uniform system of examination, the uniform valuation of securities held by insurers, and the promulgation of a wide range of model laws in regulation for adoption by the States, the NAIC has been instrumental in the development of a system of solvency regulation which has proven to be uniquely effective in the protection of American consumers from the harm that can come from the insolvency of financial institutions.

As I testified before this committee in February, this process has culminated in the development of a set of national minimum standards for solvency regulation and an accreditation program designed to encourage the 50-State implementation of those standards. I am pleased to report that in 1991 alone 15 States have already adopted NAIC models contained in the financial regulation standards and another 28 States are currently considering the adoption of these solvency models.

With every passing week, it becomes increasingly clear that my previous prediction to you that 1991 would see the passage of more proconsumer legislation than any previous year in our history will prove to be, if anything, understated.

When financial troubles befall an especially large company, as happened in the early 1980's with the bankruptcy of the Baldwin United Corp. and the resultant problems for its insurance company subsidiaries, State regulators are called upon to elevate the level of interstate coordination. In the Baldwin United situation, we answered that call. Yet, as successful as those efforts were in assuring that insurance consumers receive 100 cents on the dollar, the process taught the regulatory community a number of valuable lessons about how to improve the system that have played a large part in the improvements in insurance regulation over the last 6 years.

Just as State insurance regulators found lessons in the trying experience of the Baldwin United bankruptcy, we have found and will continue to find important lessons in our experience with the Executive Life companies, expanding the capacity of the insurance regulatory system to meet the challenges of regulating this evolving industry.

As sound as State regulation of this industry is, we know it can be improved. I am confident, however, that the efforts of the NAIC, individual State insurance regulators, and State legislators are on the right tract, the fast track, and are positioning the States to more effectively regulate the solvency of this industry.

Again, I would like to thank you for this opportunity to present the NAIC's testimony on this important subject, and will be happy later on to take your questions.

Senator BRYAN. Thank you very much, Mr. McCartney.

Mr. Weiss, we have your full testimony submitted, and it will be made a part of the record. We welcome you to the hearing, sir.

Mr. McCartney. Thank you.

STATEMENT OF MARTIN D. WEISS, PRESIDENT, WEISS RESEARCH, INC., WEST PALM BEACH, FL

Mr. WEISS. Thank you, Mr. Chairman and committee members, for this opportunity to testify today.

My name is Martin Weiss. I am the president of Weiss Research, Incorporated, of West Palm Beach, FL. And with me today is Ted Brownstein, the director of insurance safety of our firm.

America's consumers owe a debt of gratitude to this committee for its timely investigation of this very vital issue. However, I am truly disappointed today that other rating agencies are not here to confront the issues head-on because, sincerely, I believe we are on the brink of a disaster which could shake the insurance industry to its very foundation.

The cause of this disaster is not limited to a handful of junk bonds and its consequences are not limited to the failure of a few weak companies.

The disaster we see ahead stems from many years of high-risk investing and it could result in many decades of hardship for millions of Americans. The disaster we fear is the looming crisis of confidence, of lost credibility, of spreading fear among the public, and ultimately of a run on the bank as policyholders pull their money out of the insurance industry.

The good news is that this disaster can be avoided, and I will suggest how in a moment. But before I turn to the future, let me discuss the present.

Our firm rates over 1,700 life, health, and annuity insurers for consumers. We are here to protect the consumer from the impact of failures such as Executive Life's. We do not accept any payment from the companies for rating them. This independence is one of the underlying reasons why we are able to warn consumers ahead of time about Executive Life's large junk bondholdings.

Unfortunately, Executive Life is not the only company which falls in this category. The new classification of junk bonds adopted by the NAIC reveals that many large companies have more than double the holdings in junk bonds than previously believed. For example, First Capital Life, also domiciled in California, has over 40 percent of its investments in junk bonds as compared to the 20 percent previously reported. Fidelity Bankers Life, a Virginia company, shows a surge in junk bondholdings to almost 38 percent from 18 percent.

In addition, many companies have large holdings in triple B bonds which, according to Moody's and S&P, have speculative characteristics. I call these bonds "near junk." These are bonds which in today's climate of rising business failures are bound to suffer a larger than normal percentage of downgrades, bloating still further the junk holdings of insurance companies.

Take, for example, United Pacific Life Insurance Co., domiciled in the State of Washington. This company has 32 percent of its investments in "near junk" triple B bonds, in addition to its 33 percent invested in junk bonds, for a grand total of 65 percent in low-quality bonds.

The total amount of junk bonds in the life and health insurance industry is $84 billion, according to the data which the NAIC has released very recently. This compares to $51 billion reported 1 year ago. In addition, the industry holds another $159 billion in "near junk." This brings the total amount of low-quality bonds to $244 billion, many times more than the industry would have us believe.

Our fear is this: By failing to disclose these facts, the insurance industry is undermining public confidence in the industry and ultimately risking the possibility of panic.

This is precisely what happened in the case of Executive Life as the earlier witnesses have testified. Despite the obvious exposure of junk bonds, regulators told the public not to worry. A.M. Best, Standard & Poor's, and Moody's, which regretfully are not here today, gave it excellent grades. The company itself had no legal requirement to disclose the risks to the consumer.

Today, other consumers are being kept in the dark about similar risks at other large companies, companies which still enjoy top ratings from the Wall Street rating agencies.

If these insurers fail, public confidence will be badly shaken. Policyholders will rush to take their money out through surrenders or policy loans and the entire industry, including some of the stronger companies, which fortunately still are there, will be threatened. This is the ultimate disaster which must be prevented.

We have two proposals. First, Congress should legislate full disclosure rules. Until now, although the insurance industry has been competing directly with Wall Street in the sale of investment products, it has been generally exempt from the full disclosure requirements which are standard under the Investment Company Act of 1940. To repeat, the role of the Federal Government should be to develop and enforce point of sale risk disclosure formats for the insurance industry.

Second, Congress should recognize that rating agencies serve the public interest in the dissemination of information. As such, they should be placed in the same category as other news media. However, the law is unclear in this area. Unless Congress passes appropriate legislation, many rating companies will be hesitant to provide accurate ratings because the risk of lawsuits is currently far greater for rating agencies than for others in the news media.

We believe that this may be one of the unsaid reasons why other rating agencies failed to warn the public about Executive Life.

We are confident that these two proposals could help relieve the regulators from the nearly impossible task of policing thousands of companies.

The best regulatory body in the world, in my opinion, is the public. But to do their job effectively, they need to have the facts.

Thank you, Mr. Chairman. I have charts and tables in my full testimony which we could discuss, if there is time.

[The prepared statement of Mr. Weiss follows:]

PREPARED STATEMENT OF MARTIN D. WEISS

INTRODUCTION

We are on the brink of a disaster which could shake the insurance industry to its very foundation.

The cause of this disaster is not limited to a handful of junk bonds. And its consequences are not limited to the failure of a few weak companies.

The disaster we see ahead stems from many years of high-risk investing and it could result in many decades of-hardship for millions of Americans.

The disaster we fear is the looming crisis of confidence, of lost credibility, of spreading fear among the public and, ultimately, of a "run on the bank" as policyholders pull their money out of the insurance industry.

The good news is that this disaster can be avoided. I will suggest how in a moment. But before I turn to the future, let me discuss the past and the present.

PART I. THE PAST

In the early 1980's, interest rates had reached an all-time high as the yield on long-term Treasury bonds topped 16 percent. As a result, policyholders were dissatisfied with the comparatively modest returns offered by traditional life insurance policies.

The industry responded with widespread promotional efforts and new products that were intended to adapt to the new environment, including universal life and variable rate annuities.

However, as Treasury yields declined, finally reaching a low of nearly 7 percent toward the end of the last decade, the insurance companies came under pressure to maintain the income levels necessary to fulfill their high yield commitments.

For many firms, the solution was often higher risk investments that would produce the needed income. Junk bonds, more speculative real estate investments and other investment schemes—considered inappropriate for an insurance company in earlier decades—became commonplace.

The National Association of Insurance Commissioners, recognizing the deterioration in the quality of bond investments, established a Security Valuation Office in New York to monitor the problem.

In 1986, schedules addressing the issue of bond quality were added to the annual statutory statement. At this time, there already was a sincere concern about the surge in low-quality junk bond investments.

William Smythe, then Executive Director of the NAIC's Security Valuation Office, wrote: "Many insurers are now buying these non-investment grade securities in large volumes, which is substantially changing the overall risk profile of their bond portfolios toward a lower quality average."

However, these efforts were not sufficient to halt the deterioration in investment safety. Rather than decreasing their investments in junk bonds, the life and health insurance companies added additional billions in junk to their portfolios. One reason is that many bonds classified as "junk" by Wall Street rating services were considered "investment grade" by the NAIC.

The recent IDS position paper entitled Will the U.S. Life Insurance Industry Keep Its Promises? contends that 20 of the largest U.S. life and health insurers "do not have adequate surplus to withstand the losses that would result" from a moderate economic downturn.

Even analysts who do not foresee immediate disaster for the insurance industry admit a problem exists. Ian Rolland, president and CEO of Lincoln National Corporation and past president of the Society of Actuaries, has spoken of "declining surplus ratios, asset default ratios and increasing investments in high-yield bonds."

FAILED PROMISES

By far the most stinging criticism of the insurance industry came from The Congressional Subcommittee On Oversight and Investigations, chaired by Representative John Dingell. Although the report targeted primarily the property and casualty companies, many of its generic comments refer to the insurance industry as a whole. In its February 1990 report, Failed Promises, the Committee concluded that:

As a result of its findings thus far, the Subcommittee believes the insurance industry is vulnerable to the types of mismanagement and fraudulent activity that led to the savings and loan crisis * * *

The business of insurance is uniquely suited to abuse by mismanagement and fraud * * * A regulatory system based on the presumption that all companies will be managed honestly, competently and prudently is doomed to failure * * *

There were many similarities and common elements among the insolvent and problem companies studied by the Subcommittee. These included rapid expansion, overreliance on managing general agents, extensive and complex reinsurance arrangements, excessive underpricing, reserve problems, false reports, recess management, gross incompetence, fraudulent activity, greed and self-dealing There were also similar failures of state regulators and independent audit firms to identify and correct such problems before they got out of control.

HEAR NO EVIL, SPEAK NO EVIL

When faced with the dire predictions just considered, some industry insiders reacted defensively. They believed that such pessimistic scenarios were "unduly harsh," "arbitrary," "malicious" and "uninformed." Furthermore, there has been a long-standing ethic against letting bad news about specific insurance companies reach the ears of consumers.

For example, the IDS study mentioned above warned of the likelihood of 20 percent of the 100 largest life and health insurers becoming insolvent in the event of a recession. An additional 20 percent was said to be "borderline." However, their study meticulously avoided naming names. Later, when our firm, Weiss Research, used similar methods to specifically identify companies likely to encounter problems and referenced their paper, IDS objected strenuously, warning us that their study was not intended to identify potentially troubled companies either explicitly or by inference.

SUGAR-COATING THE PROBLEMS

Meanwhile, in order to avoid giving negative ratings and yet maintain some sort of scale, the long-established rating agencies—A.M. Best, Moody's and S&P—rate companies according to shades of excellence.

Traditional rating systems effectively hide companies' problems from the average consumer. Troubled insurers are not identified as such. And there is no clear warning against doing business with any company regardless of how weak or troubled it is. Specifically we find that:

A.M. Best issues no bad ratings. A.M. Best uses AK (Superior), A (Excellent), A— (Excellent), B+ (Very Good), B (Good), B— (Good), C+ (Fairly Good), C (Fair) and C— (Fair). They have no rating categories indicating "poor" or "weak." Surely weak companies do exist. Perhaps an analyst, with a knowledge of Best's ratings distribution, will interpret a "Good" or "Fair" rating as an indication of weakness. However, like help is given to the unsophisticated consumer who naturally believes that a "Good" rating identifies a good company.

Additionally, no help is provided to truly distinguish the outstanding from the average companies. Until 1989, when Executive Life's troubles were widely divulged by the media, all large companies with assets over $10 billion received A+ ratings from Best.

Even Best's use of its own C (Fair) rating is rare. We could find only 12 companies rated C and 1 rated C—. Sixty-six additional companies were given an NA-7, indicating "not rated" due to the failure to meet the minimum standard for a C— rating. Meanwhile, 522 companies have an A+ or A, amounting approximately 60 percent of the 879 rated companies. In short, it is generally a foregone conclusion that most companies will do well.

Additionally, A.M. Best will not issue a rating if a company denies it permission to do so. This fails to safeguard the interests of the consumer.

Moody's—no companies rated B or lower. Moody's does have lower categories—Ba (Questionable), B (Poor), Caa (Very Poor), Ca (Extremely Poor) and C (Lowest). But until 1989, no company actually carried one of these lower ratings. The sole exception is also Executive Life, whose rating was lowered to Ba2 in March 1990 after press reports were widely circulated and finally to B1 in April 1991.

All other life and health insurers are rated at least Baa (Adequate). There are no companies rated Caa, Ca or C. Thus, in practical terms, Moody's has provided like help in identifying potential insolvencies.

S&P—all firms "offer good financial security." Standard & Poor's also has designations for what they term companies with "speculative claims-paying ability." These are B, CCC, CC, C and D. However, as of this writing, these lower ratings have not been issued to any insurer, except Executive Life.

Other than the instance cited above, no life insurer has ever been rated BB or lower by S&P. The lowest rating issued by S&P is BBB, which it says indicates the company "offers good financial security."

CONFLICTS OF INTEREST

In short, too often insurance rating agencies work hand in glove with the companies they rate. None of the agencies cited above are willing to rate a weak insurance company as "weak," despite general knowledge of decreasing profit margins, increasing investment risk (as evidenced by huge holdings in junk bonds and other speculative investments), a decade of declining capital and the surge in insurance company failures.

Certainly weak companies do exist. And many are large, as reported by the IDS study and by Congressional investigations. Unfortunately, the traditional rating agencies have not undertaken the role of identifying weak insurers. How is the consumer to find out which companies are troubled or potentially troubled?

INSURANCE REGULATORS FAIL TO INFORM THE PUBLIC

Insurance regulators in all 50 states and the District of Columbia have a public trust to safeguard the consumer's interests. Yet they often provide no information to the public about troubled or potentially troubled companies.

The behavior of regulators and the rating agencies at the time of Baldwin to United's collapse—and, more recently, prior to the First Executive collapse—illustrates the inadequacy of the warning that consumers can expect in response to present and future problems.

A BRIEF HISTORY OF BALDWIN-UNITED'S INSOLVENCY

Baldwin's entry into the insurance field did not occur until 1970, when it acquired the first of the National Farmers Union Insurance companies. Throughout the 1970's, growth continued by acquisition of both banking and insurance firms.

Baldwin-United was formed in 1978. During the next four years, the firm experienced an impressive growth rate and high profitability as it aggressively marketed its single premium deferred annuity and whole life products. Baldwin received a steady stream of glowing reports in the financial press. The two major Baldwin-United companies, National Investors and University Life, were both rated A (Excellent) by Best & Co. for 1981.

Troubles had already begun to surface during the third quarter of 1981, but few analysts paid attention to what was deemed by industry insiders as "alarmist articles" that appeared in the press. Interest rates were dropping across the country but the Baldwin-United companies continued offering high yields and crediting to annuitants more than they earned on deposits. The condition of these firms continued to deteriorate, and by July 1983, they were placed under state supervision in Arkansas and Indiana.

The major rating agencies did like to forewarn the public of the potential for danger inherent both in Baldwin's rapid growth and its interest rate risk. Ratings fell only as the structure of the company was actually crumbling.

On the failure of state insurance regulators to effectively serve the public interest, John Fitzgerald, writing in the March 1988 issue of Journal of Insurance Regulation, said:

"To this researcher, perhaps the most striking event was the lack of meaningful disclosure by insurance regulators prior to Baldwin-United's demise * * *

"The Arkansas Insurance Department established a four-person telephone committee to handle the large volume inquiring about B-U. Every Monday morning, committee members were given scripts to read to policyholders. The operators were given strict instructions; they were to give no other information than that provided by the script * * *"

To substantiate this statement, Fitzgerald quoted the deposition of a legal secretary at the Arkansas Insurance Department: "We told people that they [National Investors Life and National Investors Pension, two Baldwin-United Companies] were licensed to do business in the State of Arkansas and that they met all the financial and legal requirements to do business there."

Similarly, less than 60 days before a moratorium freezing all payments by the firm, the NAIC declared that "Baldwin-United is adequately serving the public interest."

Both the State of Arkansas and the NAIC apparently knew at the time that this was untrue. They had clear information indicating that the firm was near failure. Yet, they felt it was their moral responsibility to protect the public from the facts.

Clearly, none of the officials involved-from the rating agencies, the state commissioners or the NAIC-accepted the role of aiding the consumer to identify and avoid potentially troubled insurers.

FIRST EXECUTIVE CORPORATION

First Executive, while different from Baldwin-United in the nature of its product offerings, is nevertheless similar in its aggressive marketing of high-yield products and associated investment risks.

Since 1985, Executive Life and its affiliate Executive Life of New York have reported that nearly half of invested assets were in bonds considered non-investment grade by the National Association of Insurance Commissioners. Despite this information, A.M. Best continued to maintain its A+ (Superior) rating. It wasn't until

January 1990, after the junk market had collapsed and after major articles in the press, that Best finally slightly lowered Executive's rating to A (Excellent).

Why did the rating agencies fail to produce ratings exposing the blatant risks being taken by this company? An A.M. Best spokesperson justifies their strategy by saying that they wanted "to give Executive Life time to work out its problems."

This policy may be effective towards the goal of protecting the insurance industry and providing it with a handy tool for promotion and sales. But it is clearly not in the interest of the consumer who requires a reliable guide regarding the ultimate safety of his investments and savings.

At the very least, the consumer has the right to know the level of risk that the company is taking. He cannot afford to stake his hard-earned money on the hope that maybe the firm will be able to work itself out of its troubles over time. Indeed, an A+ rating fails even the minimal requirement of raising some sort of warning flag which might encourage the consumer to investigate further.

Meanwhile, Moody's gave Executive Life a 1989 rating of Al. While this is not their top rating category, it fails to adequately reflect the seriousness of the potential problems. Moody's Insurance Credit report on the company, dated July 1989, gave Executive a risk-adjusted capital ratio of 119.8 percent and contended that the company had adequate capital to carry its investment risk. In the words of the report: "We believe that Executive Life is adequately capitalized."

We believe that the provisions for junk bond losses used in Moody's analysis were much too low, failing to expose the extent of potential problems. Moody's rating was subsequently downgraded to Baa2 in January of 1990 and again to Ba2 in February. But as was the case with A.M. Best, these downgrades were not announced until long after the press and a downturn in the junk bond market had exposed First Executive's speculative investment strategy.

These ratings had little or no predictive power. A heavier provision for junk bond losses was clearly needed. However, Moody's revision to their risk-adjusted capital ratio calculation in March 1990 contained no increase in this critical area.

Meanwhile, Standard & Poor's maintained Executive Life's BBB rating through November 1990, indicating that the firm continued to offer good financial security. The rating was maintained despite a dramatic run on policy surrenders during the first half of 1990, amounting to over $2 billion and the collapse of the junk bond markets. Not until April of 1991, was a rating issued that clearly warned consumers. At that time, Executive Life's rating was lowered to single B, identifying the claims-paying ability of the company as "speculative."

THE PAUCITY OF INFORMATION FOR THE CONSUMER

In sum, looking at the industry as a whole, there are persistent signs of trouble. Yet regulators and rating agencies have not brought the matter to the public's attention. Moreover, there has been very little change in the ratings of large insurers.

Nevertheless, when the audience is restricted to industry insiders and professionals, we have documented how analysts have repeatedly admitted that there has indeed been a severe deterioration of insurance company safety in recent years.

Best's Review, month after month, contains articles documenting the fact that industry-wide difficulties are steadily increasing. And as we have shown, many industry experts have expressed a real concern over persistent and worsening problems such as undercapitalization, declining bond quality, vulnerability to a softening real estate market and underpricing. In short, they recognize a problem in the industry as a whole.

However, when it comes to the weaknesses of individual companies which make up this industry, we have seen how regulators and rating agencies have failed to effectively alert the public to the potential for trouble. One motivating force is the concern that public knowledge of an insurer's problems might cause a "run" on a company.

With this rationale, the industry, as well as most of those that analyze it, have failed in their basic responsibility of reporting the facts in an objective and understandable manner. This, in turn, gave certain companies the ability to continue their high-risk investment policies and unsound business practices, luring an ever larger number of consumers into unsafe insurance policies.

PART II. THE PRESENT

Currently, we see very little movement toward greater frankness. We applaud the efforts of this Committee and the Dingell Committee to uncover the facts. We also applaud the work of the NAIC in its attempt to improve its classification of bonds held by insurance companies.

However, the consumer still has great difficulty in acquiring the information he needs to make rational choices. For example, he cannot determine which are the firms that IDS has predicted would fail during the next recession. And it is very difficult for him to find out which firms, among those rated A+ by A.M. Best, are truly worthy of his trust.

THE WEISS RATING SYSTEM

Our firm, Weiss Research, has helped to fill this gap with the Weiss Rating System, developed by our Director of Insurance Safety, Ted Brownstein. We are an independent rating agency with a conservative, consumer-oriented perspective.

We rate over 1,700 life, health and annuity insurers for consumers. Our goal is to protect the consumer from the impact of failures such as Executive Life.

We do not accept any payment from the companies for rating them. Nor are we dependent on their cooperation for our data. This independence is one of the reasons why we were able to warn consumers, well ahead of time, about Executive Life's large junk bond holdings.

In contrast to those of other rating agencies, Weiss Insurance Safety Ratings have sought to flag potential problems in such a way that the average consumer will be adequately informed in a timely fashion. The potential for problems at Executive was clear. Therefore, when Weiss Research first released its service to the public in August 1989, Executive Life was immediately given a FAIR rating. Clients were told to "approach this company with caution." In early 1990, we then downgraded the firm to WEAK.

How were we able to detect these weaknesses while other firms were either unable or unwilling to do so? To answer this question, we present here a brief summary of our methodology.

We have been analyzing the safety of the insurance industry since our the firm was founded in 1971. But it wasn't until August 1989 that we broadened our research to include most health and life insurers. Our publications include The Personal Insurance Safety Reports and The Quarterly Insurance Safety Directory which contains ratings of 1,742 life, health and annuity insurance companies. The Weiss rating system has five major components:

1. Risk-Adjusted Capital Ratios. These essentially answer the question: In view of the risks the firm is taking in its investments and its line-of-business mix, does it have sufficient capital resources to cover the potential losses the firm could incur under worsening economic conditions?

To address this issue, we determine: (1) "target capital"—the total we feel the firm should have to cover its risks and (2) "total capital resources"—the amount the firm actually does possess. Last, we divide the actual capital resources by the target capital to arrive at (3) the risk-adjusted capital ratio.

2. The Investment Safety Index. How safe are the company's investments? To address this question, each investment category is assigned a relative risk factor, the composite of which produces the index.

3. The Policy Leverage Index. Based upon line of business and in proportion to its capital resources, to what degree has the company made commitments to its policyholders?

4. The 5-Year Profitability Index. Here we evaluate the gain or loss on operations by line of business, consistency of operating results, impact of operating results on surplus, adequacy of investment income as compared to the needs of policy reserves, and expenses as a percent of revenues.

5. The Stability Index. This index incorporates an insolvency model that correlates instabilities found in a company's operations over the last three years.

Each of these indexes, in turn, have many components which themselves are derived from a series of subcomponents. Although it is not possible to document here the full range of calculations we make to determine a company's overall rating, the salient features of the rating system are discussed in Appendix A.

HOW THE WEISS RATING SYSTEM DIFFERS FROM OTHER RATING SYSTEMS

The underlying assumptions, methodology and final results of the Weiss Rating System contrast markedly with those used by other rating agencies:

1. The impact of a recession. Rather than focusing primarily on current claims-paying ability, we place heavier emphasis on the ability of a firm to cover claims in the future or in the face of economic adversity. Thus, while other rating systems largely overlook the consequences of a severe recession, ours has already factored in its potential impact.

With the economy now in a declining mode, the foresight of such an approach is now clear. The Weiss ratings reflect the potential impact of a recession on new business, policy surrenders, policy loans, claims, bond and mortgage default rates, loss of investment income, decline in market value of invested assets, capitalization and other factors.

2. Realistic risk factors. We use risk factors that, objectively speaking, are more realistic in view of current economic conditions. As documented in Appendix A, it would be clear to any economist that the risk assumptions made by the regulators and other rating agencies are both overly optimistic and out of line with the true conditions.

This applies not only to junk bonds but, most significantly, to real estate and mortgages. Both the state commissioners and the traditional rating agencies have been ill-prepared for the recent sharp declines in real estate values in the Northeast and other areas. These declines are now widely recognized as having a substantial impact on financial institutions. Nevertheless, both the traditional rating agencies and regulators remain, as before, complacent regarding past, present and future real estate deflation and regarding growing mortgage default rates.

State commissioners have no provision for reserving for real estate losses, although' the issue has been "under study" for quite some time. Meanwhile, Moody's ratings assume a maximum loss of a meager 5 percent—an amount which understates many of the declines which have already been recorded and falls short of the possible declines during a continued economic downturn.

In contrast, the Weiss Rating System has, from the very outset, built-in mechanisms for incorporating the true risks associated with real estate. There is a negative impact on the Investment Safety Index commensurate with the proportion of the total invested assets in the real estate area. Our Risk-Adjusted Capital Ratio #2 (which assumes a severe recession scenario) estimates potential losses which range from 33 percent to 50 percent depending on the category of real estate. As recently as early 1990, these levels were criticized by the industry as being excessive. However, many now view them as appropriate, with some real estate experts indicating that even larger declines are possible.

One reason that the authorities have been slow to recognize the dangers in this area stems from the fact that, since the end of World War II, real estate has steadily appreciated. An assumption therefore developed that market values would continue to rise indefinitely. Not only was this assumption wrong in theory (since real estate values are tied to the general health of the economy), but it also failed to pay sufficient attention to the softening in real estate already underway.

With the Resolution Trust Corporation unloading billions of dollars worth of property and with declining prices in the Southwest and Northeast, there is ample reason for concern about the safety of mortgage assets. And as evidenced by recent activities of the Comptroller of the Currency, which has been carefully scrutinizing the real estate loans of major commercial banks in New England and the Southeast, this concern is shared by many regulators in the banking industry.

The threat to mortgage assets—a heavy component in many investment portfolios of insurers—is a direct consequence of the real estate decline. It is not unreasonable to expect that, during tough times, a rise in mortgage default rates coupled with significant declines in underlying property values could result in losses in excess of 10 percent in the mortgage portfolios of insurance companies. This factor alone would be enough to put some large companies which have a large percentage of their total assets in directly held mortgage paper and/or mortgage pools.

Insurance industry defenders contend that they are immune to these problems because they do not suffer from the liquidity demands which can impact other financial institutions. Therefore, they believe there is no pressing need to mark down their assets. The recent experience of Executive Life, however, should dissuade one of the notion that liquidity is not potentially a critical issue.

It is important to remember that many of these large companies have only three or four percent of capital to assets and do not have the resources to withstand heavy losses. Therefore, the insurance consuming public needs to be alerted to those companies with large mortgage/real estate exposure. In order to accomplish this goal, a significant provision for mortgage related losses in our risk-adjusted capital calculation helps to between distinguish companies which are well-positioned to absorb such losses and those which are not (see Appendix A).

3. A data-oriented approach. Our methodology is purely objective, removing the unquantifiable judgment factors that often enters into the ratings by other firms. This deliberately excludes such factors as the experience of management or the likelihood of an affiliate coming to the rescue of a troubled insurer.

Indeed, the subjective nature of these factors is often used by other rating agencies as camouflage, making it impossible for outside observers to reproduce the methodology by which a particular rating is derived. Although the specific programs used in our methodology are proprietary, the essential elements and concepts have been available upon request and are laid out in this testimony.

We believe that a data-oriented approach, which takes into account the unique characteristics of each firm but allows no room for favoritism, is the only equitable and fair method.

4. Independence. Our firm retains full independence from the industry which it rates. We do not depend on the companies for our revenues, for our source of data or for any other aspect of our rating system. Unlike those of other rating agencies which often serve the industry, most of our customers are the end users of insurance products. Our data is derived primarily from annual and quarterly financial statements which we obtain from the state insurance commissioners.

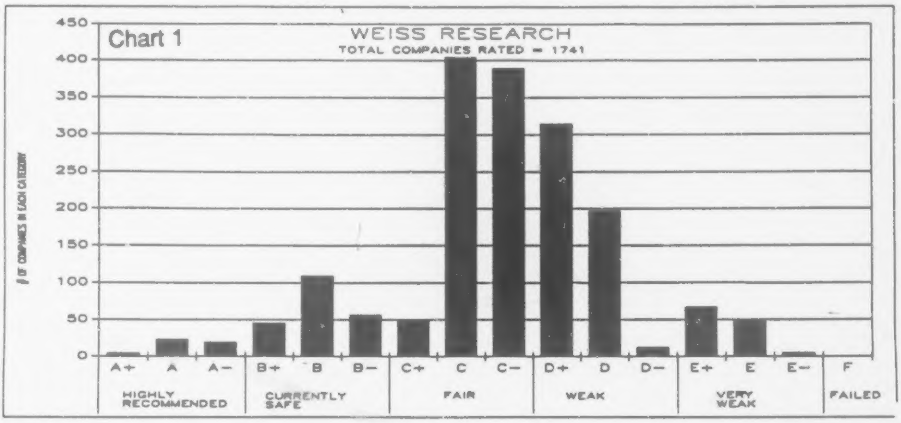
We send out surveys to the companies for data verification and additional detail. However, when a company fails to respond to our surveys, we base our rating exclusively on the data as obtained from the state insurance commissioners.

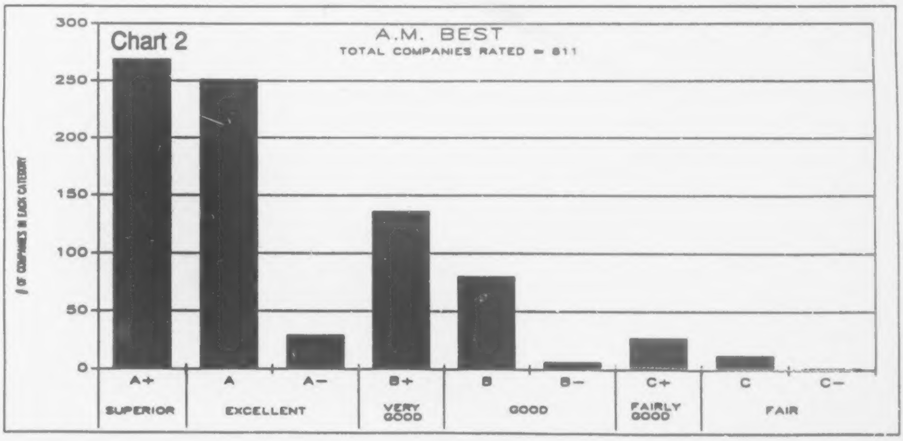
Although we seek to maintain an open line of communication with the companies, we do not ask companies for permission to rate them. Nor do we give them veto power over the publication of the results. We are willing to rate companies based on public data and make the necessary conservative assumptions when companies do not choose to provide the additional data we request.

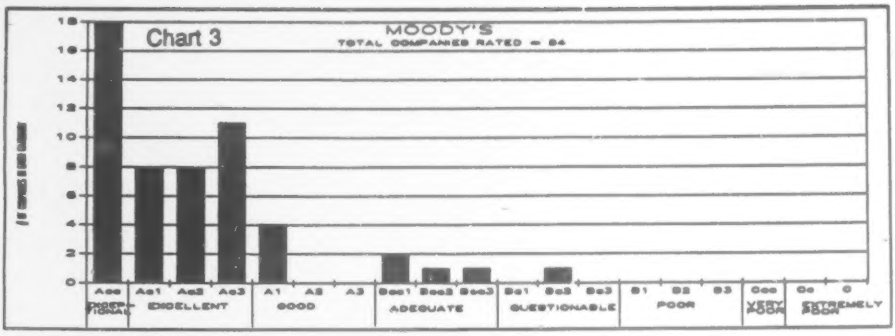
5. More balanced results. As we have outlined above, the distribution of ratings provided by other rating agencies is heavily skewed to the top of the scale, with most or all large companies given a high grade. In contrast, the Weiss ratings follow a normal distribution curve (see Charts 1 through 4).

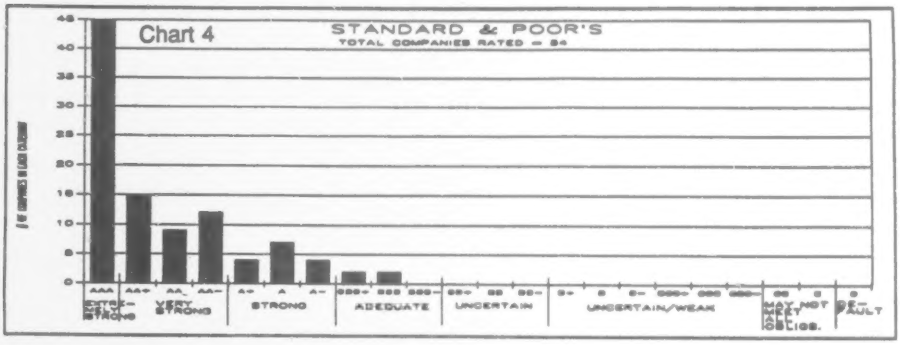
Insurance Company Safety Ratings Comparison Graphs

The following graphs show that Weiss Research Insurance Safety Ratings are evenly distributed, whereas those of other services are skewed to the high end of the rating scale.









In the Weiss Ratings, only a minority of firms receive ratings on either extreme of the scale, with the largest percentage of firms in the broad middle ground. Similarly, among the very large firms, there are some that are strong, some that are weak and many that are in between. We believe this even-handed approach helps fill the gap created by the skewed approach of other rating agencies and by the failure of state regulators to provide accurate information to the public.

OUR POSITION AND TRACK RECORD

Weiss Research is part of a small minority of analysts that has been willing to counter the industry's long-standing ethic against letting negative information about specific companies reach the public's ears.

This is based on the conviction that open access to information, whether bringing good news or bad news, is in the interest of the consumer. Furthermore, in the long term, a well-informed consumer who is able to make rational choices is the best prevention against irrational or panicky responses which could otherwise threaten the liquidity of even the strongest insurers.

Weiss Research has identified both the strongest and weakest life and health insurers. In addition to warning the public of the potential troubles at First Executive—well before their troubles were highlighted in the media—we have identified numerous weak companies which have subsequently been placed under state supervision. The following table lists those companies and shows the Weiss Rating issued at least one year prior to their being taken over by the regulators.

List of All Companies Placed Under Supervision of State Insurance Department 1/1/89 Through 5/1/91 With Weiss Ratings

Allied Bankers Life Insurance Co	E	Very Weak
Amalgamated Labor Life Insurance Co	D	Weak
American Equitable Life Insurance Co	E+	Very Weak
American Independence Life Insurance Co	E+	Very Weak
American Standard Life & Accident Insurance Co	D	Weak
American Sun Life Insurance Co	D	Weak
American Teachers Life Insurance Co	E+	Very Weak
Americas Life Insurance Co	E+	Very Weak
Benicorp Insurance Co	E+	Very Weak
Cadillac Insurance Co	E+	Very Weak*

List of All Companies Placed Under Supervision of State Insurance Department 1/1/89 Through 5/1/91 With Weiss Ratings—Continued

California Pacific Life Insurance Co	E–	Very Weak
Consolidated Benefit Health Insurance Co	E+	Very Weak
Continental Security Life Insurance Co	D+	Weak
Executive Life Insurance Co	D	Weak*
Executive Life Insurance Co. of NY	D	Weak*
Farwest American Assurance Co	C	Fair
First Farwest Life Insurance Co	E–	Very Weak
GIC Insurance Co	E	Very Weak
Galaxia Life Insurance Co	D+	Weak
Guardian American Life Insurance Co	E	Very Weak
Independence Life Insurance Co. (LA)	D	Weak*
Iinickerbocker Life Insurance Co	E	Very Weak
Life Of Indiana Insurance Co	D	Weak
Louisiana Life Insurance Co	E–	Very Weak
Midwestern Life Insurance Co	E+	Very Weak
Missouri National Life Insurance Co	D	Weak
Modern Pioneers Life Insurance Co	D	Weak
National Producers Reassurance Co	E+	Very Weak
Navajo Life Insurance Co	E+	Very Weak
Pacific Standard Life Insurance Co. (CA)	E	Very Weak*
Professional Investors Life Insurance Co	E+	Very Weak*
Progress Life And Accident	E–	Very Weak*
Regent Life Insurance Co	E–	Very Weak
Rumford Life Insurance Co	E	Very Weak*
Security Southwest Life Insurance Co	D	Weak
Southern General Life Insurance Co	E	Very Weak
Texas Consumer Life Insurance Co	E–	Very Weak
U.S. Annuity Life Insurance Co	E+	Very Weak

* Indicates Companies Added Since 3/31/90.

INDUSTRY CRITICISM OF WEISS RATINGS

Many in the insurance industry, unhappy with the potential impact of our ratings upon their sales, have naturally sought to criticize the underlying assumptions and methodology used. Some of the industry's defenders contend that we don't give enough good ratings, we're "too conservative" or that "we don't consider individual lines of business." Some companies with large holdings in moral obligation government securities would like to see us put them in the same class as full-faith-and-credit government securities. Additionally, some companies feel that we should meet with their executives personally to better understand the particulars of their business. The following represents our position on these issues:

1. Finding the very best companies. The Weiss Rating System finds those exceptional companies with the safest investment portfolios, the highest capitalization and consistent profitability. Finding the few companies that are the "cream of the crop" is clearly a service to consumers. Furthermore, as stated earlier, unlike that of other rating agencies, the distribution of Weiss Ratings follows a normal curve. There are only a limited number of companies in either the best or worst categories, with the majority distributed over a broad range between these two extremes. Furthermore, included on the 1991 List of Recommended Companies with strong or good safety ratings are numerous major firms including State Farm Life, Massachusetts Mutual, New York Life, Northwestern Mutual and Metropolitan Life.

2. Conservative approach. The Weiss Rating System was developed when a recession and other financial difficulties were believed by most observers to be unlikely. Even at that time, we feel it was unreasonable for analysts to negate the possibility of a worsening economic environment in the decades ahead. Moreover, currently economists have officially recognized that we are in a recession, with many admitting that it could be both severe and prolonged. These new developments confirm the validity of the underlying assumptions made in the Weiss System with respect to junk bonds, real estate, mortgages and other vulnerable areas.

3. Adjusting for different lines of business. The Weiss Rating System integrates each individual company's mix of business in a variety of ways:

a. In our Risk-Adjusted Capital Ratios, different potential loss factors are assigned, by line of business, based both on the premiums and reserves. (See Appendix A, Table 1.)

b. In our Leverage Index, premium income is weighted by line of business in relation to capital.

c. In our 5-Year Profitability Index, target returns are different according to line of business.

d. The Stability Index views abrupt changes in the mix business as a potential destabilizing factor.

4. Government securities. In the Weiss Rating System, "government securities" are defined as those which are issued directly by the Treasury (such as Treasury bills, notes and bonds) or those which have a full-faith-and-credit guaranty (such as Ginnie Maes). However, in conformity to the statutory accounting, our system excludes non-government guaranteed agency bonds or those which are considered merely a "moral obligation" of the U.S. Government, such as the and CMO issues. There is no statutory basis for the view by insurers that all government related issues should be counted as government securities regardless of issuing authority. Furthermore, the Treasury Department has urged Congress to require these government-sponsored enterprises to obtain credit ratings without factoring in the government's implicit guarantee. Thomas Gillis, a managing director at Standard & Poor's Corp., has stated that in order to meet the requirements for a triple-A rating, Fannie Mae and Freddie Mac would have to make "fairly significant changes to their balance sheets and operations." (Wall Street Journal, May 15, 1990.)

5. Objective analysis. We believe that overreliance on the company's cooperation for data and revenues, in conjunction with direct personal visits, would only open the door to potential conflicts of interest. Weiss Research is independent of the industry, both for its data and revenues. Data is derived primarily from yearly and quarterly statutory statements. Weiss Research also surveys more than 1,700 life and health insurers, requesting additional data not available through public sources, such as detailed breakdowns of bond holdings and premium income by line of business as well as information concerning reserving practices, surrender values and asset/liability matching.

The Weiss system is flexible in that it allows adjustments based on a wide range of variables, either from public sources or from materials submitted by the firms directly. However, if a company refuses to provide requested information, Weiss Research will proceed exclusively with public data, thereby preserving its independence and neutrality.

INDEPENDENT APPROACH

In sum, Weiss Safety Ratings are justifiably more conservative and consumer-oriented than other ratings available today. Large, household-name companies do not automatically get excellent ratings. Rather, among insurers with more than $10 billion in assets, ratings range from A+ to D+, with the majority in the B to C range. Only the truly exceptional companies get excellent ratings.

Weiss' rating distribution clearly does not conform to the industry ethic prohibiting disclosure by insiders of company weaknesses to the general public. Our B or C ratings, although not unfavorable to the companies, do not provide a basis for insurance agents to boast about the companies they represent.

Weiss Research is a consumer-advocacy reporting service and, towards that end, will remain independent of any industry pressure.

THE STATE OF THE INDUSTRY

Unfortunately, Executive Life is not the only insurance company which harbors great financial weaknesses. In fact, among the larger insurers, there are many whose weaknesses have been greatly underestimated by most analysts.

WEAKNESS #1. JUNK BONDS

In consonance with their policy of seeking to always portray the industry in a positive light, most regulators and rating agencies will tell you that only a few companies have excessive junk, that Executive Life's failure was an isolated case, and that the problem will soon go away. This is not true.

Many large life insurance companies have approximately double the amount of junk bonds previously revealed by the authorities, based on year-end 1990 data analyzed by Weiss Research. The following are the largest junk bondholders:

- First Capital Life Insurance Company (CA) appeared to have 20.2 percent of its invested assets in junk bonds, based on 1989 data. The new official data, which uses a more realistic bond classification, shows that First Capital actually has an alarming 40.7 percent of its invested assets in junk bonds.
- Fidelity Bankers Life Insurance Company (VA) shows a surge in reported junk bond holdings to 37.6 percent of invested assets from the previous 18.3 percent.

- **The junk bond holdings of United Pacific Life Insurance Company (WA) jumped to 32.9 percent from 14.3 percent.**

Similarly, large firms such as Anchor National Life Insurance Company (CA), Kemper Investors Life Insurance Company (IL), Jackson National Life Insurance Company (MI) and many others show big increases in their reported junk bonds:

Chart 5.—Junk Bond Holdings as A Percent of Invested Assets

[Insurers with $4 billion or more in assets and 10 percent or more in junk bonds]

Company	State	[1] 1989	[2] 1990
Executive Life Insurance Co	CA	50.7	67.7
First Capital Life Insurance Co	CA	20.2	40.7
Fidelity Bankers Life Insurance Co	VA	18.3	37.6
United Pacific Life Insurance Co	WA	14.3	32.9
Anchor National Life Insurance Co	CA	12.2	22.6
Kemper Investors Life Insurance Co	IL	13.8	22.4
Jackson National Life Insurance Co	MI	14.5	19.3
Northwestern National Life	MN	7.3	16.9
Sun Life Insurance Co. of America	MD	9.6	14.4
Fidelity & Guaranty Life Insurance Co	MD	7.9	12.9
Pruco Life Insurance Co	AZ	8.4	12.3
Monarch Life Insurance Co	MA	3.7	11.9
Keyport Life Insurance Co	RI	5.5	11.1
Allstate Life Insurance Co	IL	5.9	10.1

SOURCE.—Statutory reports filed with the State insurance commissioners.

[1] 12/31/89 data includes all bonds designated by State commissioners as "No*," and "No**," and "No."

[2] 12/31/90 data includes all issues in classes 3 through 6, which are the equivalent of BB or lower.

Until now, the state insurance commissioners had failed to reveal the true magnitude of the junk bond problem because previously, thousands of bonds identified as "speculative investments" (junk bonds) by Moody's or Standard & Poor's were classified as "investment grade" by insurance regulators. The new official data proves that Executive Life is not the only firm that has excessive junk bond holdings and not the only firm which is vulnerable to failure.

For the first time, the official data allows analysts to determine the proportion held in junk bonds. However, the state insurance commissioners are still not admitting that these bonds are below investment grade. They are still using terminology which disguises the true nature of these holdings (see Chart 6.)

Chart 6. A Comparison of Bond Classifications

NAIC OLD CLASSIFICATIONS				NAIC NEW CLASSIFICATIONS				
Name	Description	Wall St Equivalent Rating	10-Yr Reserving Percentage	Name	Description	Wall St Equivalent Rating	Wall St Description	10-Yr Reserving Percentage
(Yes X) Yes	Investment Grade	AAA, AA, A, BBB BB, B (Junk)	2%	1	Highest quality	AAA, AA, A and equivalent private placements	AAA - Best quality high grade bonds AA - High quality high grade bonds A - Upper medium grade, elements of susceptibility to future impairment	1%
				2	High quality	BBB and equivalent private placements	BBB - Medium grade, with speculative characteristics	2%
				3	Medium quality	BB	BB - Speculative elements, uncertain future	5%
No*	Non-Investment grade, above average quality		10%	4	Low quality	B	B - Undesirable, small assurance of payment	10%
No**	Non-Investment grade, below average quality		20%	5	Lowest quality	CCC, CC, C	CCC - Poor standing, may be in default CC - Highly speculative, often in default C - Lowest rated	20%
No	In, or near, default		20%	6	In, or near, default			20%

WEAKNESS #2. "NEAR JUNK"

In addition to junk bonds, Chart 7 shows that many companies have large holdings in triple-B bonds which we call "near junk." These are the bonds which are on the borderline if investment grade and which are the most likely to become "fallen angels." Wall Street describes them as "investment grade bonds with speculative characteristics." Already, due to the surge in business failures, they are suffering a larger-than-normal percentage of downgrades, bloating still further the junk holdings of insurance companies.

Take, for example, the United Pacific Life Insurance Company, domiciled in the state of Washington. This company has 32 percent of its investments in "near junk" bonds in addition to its 33 percent invested in junk bonds, for a grand total of 65 percent in low-quality bonds.

The total amount of junk bonds in the life and health industry as of year-end 1990 is $84 billion as compared to $51 billion reported on 12/31/89. In addition, the year-end 1990 data shows that industry holds another $159 billion in near junk. This brings the total amount of low-quality bonds to $244 billion—many times more than the industry would have us believe.

Chart 7.—Low-Quality Bond Holdings of Life & Health Insurers

[Companies with $5 billion or more in admitted assets; see Appendix 8 for more complete listings]

[Percent]

Company	State	Junk bonds[1]	BBB bonds[2]	Junk plus BBB bonds
Executive Life Insurance Co	CA	67.7	0.8	68.5
United Pacific Life Insurance Co	WA	32.9	31.9	64.8
SAFECO Life Insurance Co	WA	9.9	29.1	39.0
Jackson National Life Insurance Co	HI	19.3	18.4	37.6
Sun Life Insurance Co. of America	MD	14.4	23.0	37.4
Kemper Investors Life Insurance Co	IL	22.4	14.1	36.5
Transaherica Occidental Lic. of California	CA	6.1	29.5	35.5
Minnesota Mutual Life Insurance Co	MN	7.5	25.1	32.7
Keyport Life Insurance Co	RI	11.1	18.4	29.5
Teachers Insurance. & Ann. Assoc. of America	NY	8.2	19.0	27.2
Principal Mutual Life Insurance Co	IA	9.2	17.7	26.8
Allstate Life Insurance Co	IL	10.1	16.4	26.5
IDS Life Insurance Co	MN	8.2	18.1	26.4
Prudential Insurance Co. of America	NJ	9.9	16.1	26.0
Equitable Variable Life Insurance Co	NY	9.1	15.4	24.5
Transamerica Life Insurance & Annuity Co	CA	6.1	18.1	24.2
Mutual Life Insurance Co. of New York	NY	9.7	14.4	24.1
State Mutual Life ASR Co. of America	MA	3.6	19.5	23.1
John Hancock Mutual Life Insurance Co	MA	6.3	16.0	22.2
Penn Mutual Life Insurance Co	PA	5.1	16.9	22.0
Massachusetts Mutual Life Insurance Co	MA	6.6	15.1	21.7
Connecticut Mutual Life Insurance Co	CT	6.4	15.0	21.4
Connecticut General Life Insurance Co	CT	8.2	13.2	21.4
Nationwide Life Insurance Co	OH	2.7	18.3	20.9
Pacific Mutual Life Insurance Co	CA	4.8	13.1	17.9
Provident National ASR Co	TN	2.4	14.7	17.1
National Home Life Assurance Co	MO	2.1	14.4	16.6
General American Life Insurance Co	MO	3.9	12.3	16.2
Equitable Life ASR. SOC. of the United States	NY	7.7	8.4	16.1
Variable Annuity Life Insurance Co	TX	1.9	14.1	16.0
New York Life Insurance & Annuity Corp	DE	3.9	11.8	15.6
New York Life Insurance Co	NY	3.5	11.9	15.5
Lincoln National Life Insurance Co	IN	4.2	11.1	15.4
Guardian Life Insurance Co. of America	NY	3.5	11.7	15.2
AETNA Life Insurance Co	CT	2.8	11.5	14.3
New England Mutual Life Insurance Co	MA	6.2	8.2	14.3
Phoenix Mutual Life Insurance Co	CT	4.3	9.8	14.1
Mutual Benefit Life Insurance Co	NJ	3.2	10.8	14.0
Northwestern Mutual Life Insurance Co	WI	3.8	9.5	13.3
Great-West Life & Annuity Insurance Co	KS	1.1	11.3	12.4
Metropolitan Life Insurance Co	NY	2.9	8.2	11.1

Chart 7.—Low-Quality Bond Holdings of Life & Health Insurers—Continued

[Companies with $5 billion or more in admitted assets; see Appendix 8 for more complete listings]

[Percent]

Company	State	Junk bonds[1]	BBB bonds[2]	Junk plus BBB bonds
American Life Insurance Co	DE	1.5	9.4	10.9
Travelers Insurance Co. Life Dept	CT	2.5	8.2	10.7
Continental Assurance Co	IL	4.6	3.5	8.2
AETNA Life Insurance & Annuity Co	CT	1.3	5.2	6.5
State Farm Life Insurance Co	IL	1.2	4.7	5.9
Hartford Life Insurance Co	CT	0.0	3.2	3.3
American Family Life ASR. Co. of Columbus, GA	GA	0.0	1.0	1.0

DATA SOURCES.—Statutory reports filed with state insurance commissioners and the National Association of Insurance Commissioners, which has provided some of the raw data. Any analysis or conclusions are not provided or endorsed by the NAIC.

[1] NAIC designations, classes 3 through 6, equivalent of BB and lower rated bonds.

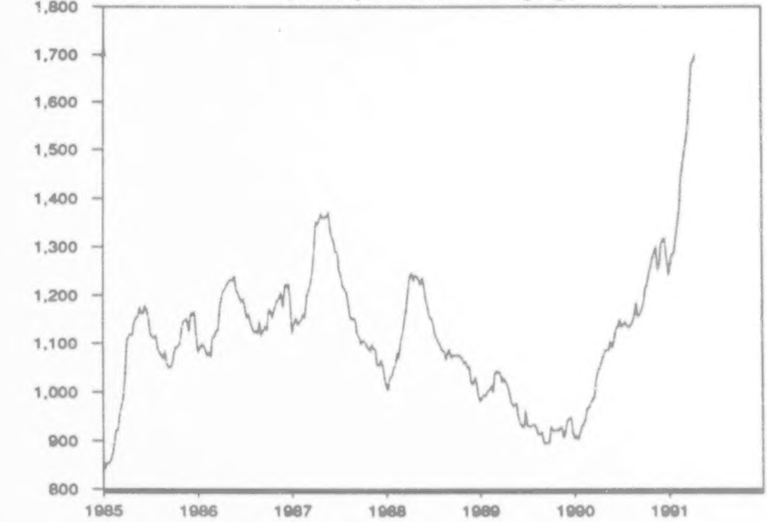
[2] NAIC designation, class 2, equivalent of BBB rated bonds.

If you consider that business failures are surging (Chart 8) and that Wall Street rating agencies are announcing record numbers of downgrades, it is very likely that a larger-than-normal percentage of these triple-B bonds will be downgraded, bloating still further the junk holdings of insurance companies.

Chart 8

BUSINESS FAILURES SURGE

(number per week, 3 wk moving avg.)



In 1990,96 corporate bond issuers defaulted on $22 billion of long-term debt, setting a new record, and the default rate on all speculative grade bonds was 8.8 percent, up from 5.6 percent in 1989. Unfortunately, these trends are continuing in recent months.

The latest dangers of triple-B bonds are highlighted by inflated standards used by Wall Street-and by the state commissioners-in rating them even after the redefinition made in 1990. Two recent reports from Moody's changes in Corporate Credit Quality, 1970-1990 and Corporate Bond Defaults and Default Rates, 1970-1990—conclude that, over the last 20 years, Moody's average ratings have been going up—from Baa in 1970, to A in 1980 and, finally, Aa in 1990.

In our opinion, although the staff at Moody's is professional and honorable, the company as a whole has drifted into an unmistakable inflation of rating standards. Here are the facts:

First, as you can clearly see in Charts 9 and 10, the financial health of America's corporations deteriorated steadily throughout the 1980's. And the decline during the

1970's (not shown on the graphs) was even greater. So, if anything, the average Moody's rating should have gone down—not up.

Chart 9

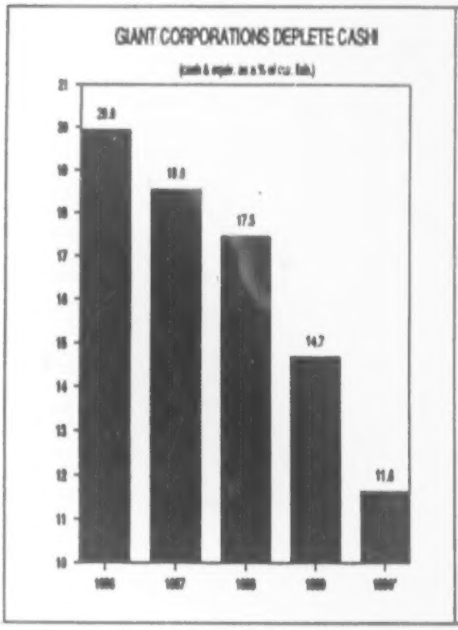
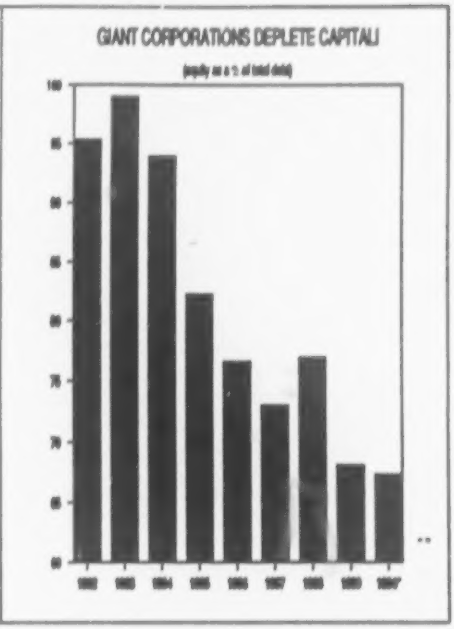


Chart 10



Second, it is clear that Moody's basic philosophy has changed. The company gives the average new issue a higher rating than it did 20 years ago. Then if something goes wrong, they downgrade the company later. The net result is that the average investor gets lured in when bond issues are brought to market and then gets locked in to losses when the issue's quality suddenly deteriorates and Moody's drops the rating.

In our opinion, the quality of many of these new issues was less than excellent to begin with. We believe that Moody's should issue more conservative ratings up front—so they wouldn't need to announce as many downgrades.

Third, the average rating has gone up even after factoring in the downgrades.

This implies that many bonds which today are rated as triple-B, might, in earlier years, have been rated as BB or lower. In short, many insurance companies, unaware of this rating inflation, may be holding much more in "junk" than they—or the commissioners—are aware of.

To their credit, some companies perform their own, independent due diligence which is stricter than that of the Wall Street rating agencies. Most companies, however, do not.

WEAKNESS #3. MORTGAGES AND REAL ESTATE

Many insurance companies carry assets similar to those which have caused severe losses to banks and S&Ls. But because the regulators assume that insurance companies are unlikely to have liquidity problems, there is no serious effort to reevaluate these assets despite surging mortgage default rates. We repeat: The recent runs on Executive Life and some other companies in trouble should dissuade regulators of the notion that liquidity problems are unlikely in this industry.

WEAKNESS #4. INSUFFICIENT CAPITAL RESOURCES

As indicated earlier, for each company we rate, we calculate how much capital would be needed in various economic scenarios. Unfortunately, only a small minority of companies has all the resources we believe they need to comfortably cover their potential investment and business losses during a severe recession.

THE PUBLIC IS STILL IN THE DARK

The public is generally unaware of any of these weaknesses. Our fear is this: By failing to disclose these facts, the insurance industry is undermining public confidence in the industry and ultimately risking the possibility of a panic.

This is precisely what happened in the case of Executive Life. Despite the obvious exposure to junk bonds we find that:

- Regulators deliberately told the public not to worry.
- The Wall Street rating agencies gave Executive Life excellent grades. A.M. Best, Standard & Poor's and Moody's gave it excellent grades.
- The sales representatives of the company itself had no legal requirement to disclose the risks to the consumer.

THE FLIGHT TO QUALITY

Although most segments of the public are generally unaware of the industry's weaknesses, a significant number of more sophisticated consumers are already shifting from companies that have had adverse publicity to those which are perceived to be stronger. It is the first stages of what could become a massive flight to quality.

Several years ago, we forecast that the next economic downturn would bring a redistribution of business among major life and health insurers from "weak to strong hands."

The losers would be those companies with substantial holdings in high-risk, high-yield investments. The winners would be those that resisted the lure of higher yields and retained the traditionally conservative investment philosophy of earlier years. Overall, the industry would benefit as high-risk companies are forced by market pressures to become more safety conscious.

Now that the economic downturn is here, has the predicted redistribution of business begun to take place? In this section of our testimony, we demonstrate that the answer is "yes."

We use the Weiss Safety Ratings as our measure of a company's overall risk levels during an average and severe recession.

Until recently, few insurance analysts had seriously considered the potential impact of an economic downturn because life insurers have traditionally been fiscally conservative and relatively immune to its potential effects. Unlike other financial institutions, they did not suffer significantly from declining asset quality, illiquidity or shrinking business.

As illustrated earlier in this testimony, however, over the past decade, the industry underwent major structural changes which greatly reduced its traditional resistance to recessions. Products sold by insurance companies became more investment-oriented with the introduction of universal and variable life, variable annuities and GICs. Consumers sought higher returns on their investments, and most major insurance companies yielded to the pressure of the marketplace. Holdings in high-risk, high-yield investments surged, notably in non-investment grade bond holdings and mortgages.

In short, the industry began the decade of the 1980's relatively immune to the vagaries of the business cycle. But it ended the decade in a state of peak vulnerability.

The Weiss Safety Ratings have been-from the outset-designed to measure this vulnerability inasmuch as one of the key components of the rating directly addresses this issue: How much does the insurance company have in capital resources to cover estimated potential losses in its investments and in its specific mix of business during a recession?

This factor, combined with other measures of financial strength, provides a basis for categorizing insurers by their relative safety. Therefore, for the purposes of this study, we believe the Weiss Ratings are an appropriate and objective measure of quality.

Although the trends toward declining capitalization and increased risk-taking began many years ago, the public's perception of the risks is more recent. The S&L crisis, despite its differences with the problems in the insurance industry, spurred deep concerns. The Dingell Committee study, regarding the potential for large-scale insurance insolvencies (cited earlier in our testimony), was also instrumental in alerting some sophisticated investors. Most important, countless articles in the media have greatly raised the public's concern. In this climate, it is natural to expect that:

1. Consumers who are currently shopping for insurance will favor firms that have maintained a conservative investment strategy. Conversely, they will tend to avoid those known to have large junk bond holdings or to have suffered severe real estate losses.
2. Consumers who currently hold policies with firms now perceived to be risky will look for opportunities to transfer their business to stronger firms.

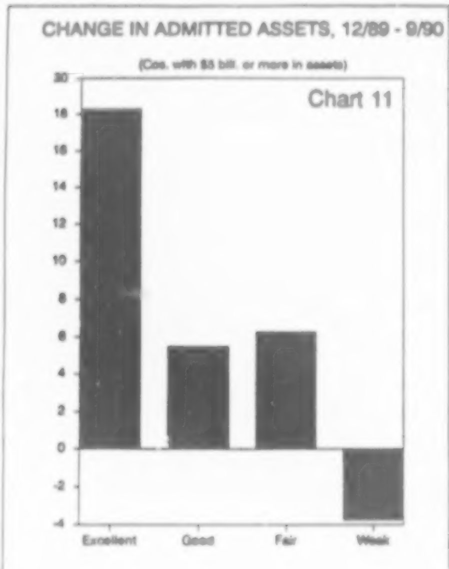
3. Conservative companies will experience above-average growth in assets and premiums, while higher risk companies will experience lower growth rates or outright shrinkage in assets and premiums.

To monitor the movement of assets and premium dollars from weak to strong hands, we divided of the largest life, health and annuity insurers into four groups, by their safety rating. We had 3 companies in the A group, 13 companies in the B group, 23 companies in the C group and 5 companies in the D group.

We then studied changes in total admitted assets, net premiums, and surplus ratios over the nine-month period from December 31,1989 to September 30,1990.

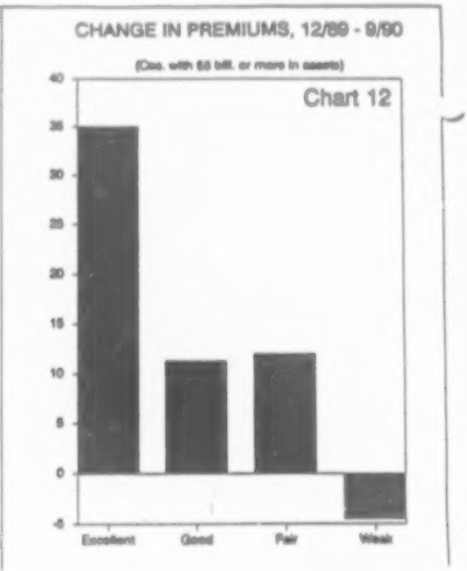
The results show preliminary signs that a flight to quality indeed may be in the works. A-rated companies outperformed all other groups, as well as the industry averages, by a considerable margin in terms of asset and premium growth.

On the opposite side of the scale, D-rated companies were clearly distinguished by an aggregate shrinkage in assets and premiums. B-rated and C-rated groups showed modest growth, with no significant differences between the two. (See Charts 11 and 12.)


CHANGE IN ADMITTED ASSETS, 12/89 - 9/90

(Cos. with $5 bill. or more in assets)

Chart 11


CHANGE IN PREMIUMS, 12/89 - 9/90

(Cos. with $5 bill. or more in assets)

Chart 12

However, within each grouping, the results are not uniform. Some companies in the C and D groups grew at a faster rate than A-rated and B-rated companies. The fact that only three A-rated companies are included in this study also tempers the interpretation of their significance. However, these statistical limitations are outweighed by the following fact: The lowest rated firms have traditionally been the most aggressive in seeking new business and have normally enjoyed the highest growth rates. The very fact that this pattern has now reversed indicates a dramatic shift in consumer psychology which now favors safety over yield.

More specifically, the study sheds light on the following areas:

1. Growth in admitted assets. During the first nine months of 1990, the industry as a whole experienced solid growth, as total admitted assets for the 44 largest companies rose by approximately $50 billion or 5.3 percent. The A-rated group saw a substantial asset growth of 18.3 percent; whereas the D-rated group saw an aggregate decline of 3.8 percent. Several firms with highly publicized problems, such as Executive Life and Equitable Life of the US, showed dramatic shrinkage. Most important, companies in the A-rated group enjoyed growth at more than three times the pace of the total growth of the 44 companies in our analysis.

2. Net premiums. The trend in net premiums confirms the trends found in admitted assets-a contraction among the D-rated companies and significant growth in the A-rated companies. The degree of change, however, was greater than that found in admitted assets.

3. Changes in surplus ratios. As a consequence of the rapid growth caused by the flight to quality, companies often experience "surplus strain"- reduction in the ratio of capital resources to assets. And this is precisely the pattern we see: a decline of 8.2 percent among the A-rated companies. In response, conservative companies will

either search out additional sources of capital or limit their growth to modest rates in order to maintain fiscal strength.

As to the weaker companies, one would hope that, under pressure from regulators, rating agencies and the public, they would take deliberate steps to improve their capital ratios. Some have. Unfortunately, the aggregate surplus ratio of the D-rated companies has not improved. And had it not been for the one-time gains from surrender fees at Executive Life, the aggregate would have declined substantially.

4. The impact of junk bond holdings. An important distinction must be made between companies that are truly safe and those that are merely perceived to be safe. Currently, for example, consumers seem most concerned about insurers with large junk bond holdings.

While this has clearly been the case with Executive Life, due to the negative media attention it has received, other firms with junk bond holdings of over two times their total net worth are still experiencing rapid growth.

This indicates that the flight to quality, although widespread, is by no means universal. There are simultaneous crosscurrents wherein some consumers are continuing to chase high yields and apparently don't understand the potential risks.

Furthermore, consumers may move from a company with 50 percent of its investments in junk bonds to one with "only" 20 percent, in the belief that their new company is safer. However, the actual safety of a company depends on many more factors other than just junk bonds. For example, one must also consider how much the company has in capital resources to absorb potential losses in junk bonds, as well as other assets.

Indeed, it is in these other risky investment particularly mortgages-that we see the biggest surprises ahead.

THE NEXT PHASE

Even after the market value of junk bonds fell sharply in the late 1980's, it took many months before the consumers realized that it might negatively impact their insurance company's investment portfolio. And as we saw above, many consumers are probably still unaware of the problem.

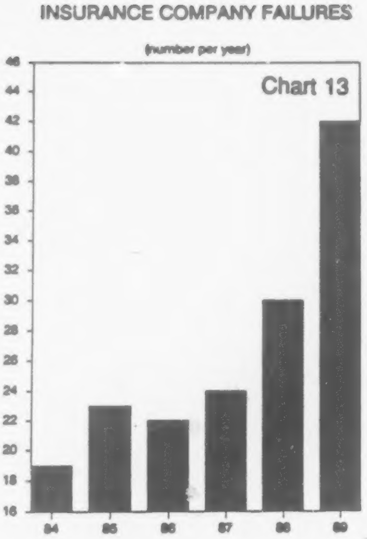
Similarly, although a major decline in real estate values is now well under way, it will take some time before consumers recognize its potential impact on their insurance. When they do gain more awareness, however, mortgage default rates and the declining resale value of the underlying real estate will emerge as key issues in the flight to quality.

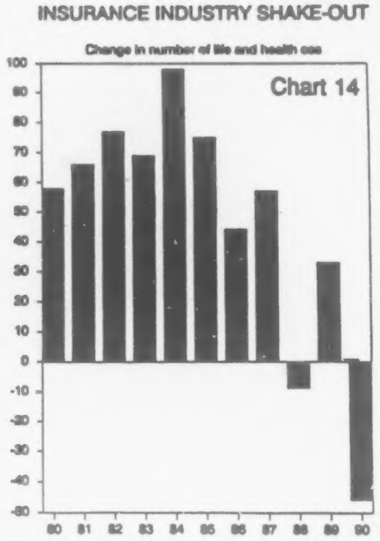
PART III. THE FUTURE

Already, even before the economic recession got under way, we began to see a surge in failures as evidenced by Chart 13.

In 1990, some of the failures have been disguised in various ways. So to better track the shake-out in the insurance industry, we are using the barometer shown in Chart 14. It is the net change in the number of life and health companies doing business. As you can see, it suffered a severe plunge in 1990.

Normally, a shake-out can be a positive development. The weak companies shrink in size due to the flight to quality (as we saw in Charts 11 and 12) and they shrink in number due to increasing failures (Charts 13 and 14). The stronger companies remain. But today, by failing to disclose these risks, the insurance industry inadvertently is risking the possibility that this flight to quality will degenerate into a wholesale panic.





THE GREATEST RISK AHEAD

Today, many more consumers are being kept in the dark about similar risks at other large insurance companies, companies which still enjoy top ratings. If these insurers fail-if the industry continues to downplay and cover up its problems- public confidence will be badly shaken. Policyholders will be driven not by reason but by emotion. They will no longer trust the word of the insurance agent, the insurance commissioner or the insurance rating agency. They will shy away from buying new insurance policies, surrender old policies, and rush to take their money out through policy loans. And, worst of all, they will have no means-and no desire-to discriminate between good or bad, weak or strong.

TWO PROPOSALS

We have two proposals which could help protect the consumer and strengthen the industry while reducing the burden to the taxpayer:

First, Congress should legislate full disclosure rules. Until now, although the insurance industry has been competing directly with Wall Street in the sale of investment products, it has been generally exempt from the full-disclosure requirements which are standard under the Investment Company Act of 1940, as amended. I propose insurance companies be required to give the consumer balanced, realistic and easy-to-understand information, such as you might find in a mutual fund prospectus.

Second, Congress should recognize that rating agencies serve the public interest in the dissemination of information. As such, they should be placed in the same category as other news media. However, the law is unclear in this area. Unless Congress passes appropriate legislation, many rating companies will be hesitant to provide accurate ratings for fear of lawsuits. We believe this may be one of the unsaid reasons why other rating agencies failed to warn the public about Executive Life.

In short, the most cost-effective vehicle for improving the long-term health of the insurance industry-and for giving consumers the protection they need-is the dissemination of easy-to-understand, balanced information.

Armed with the facts, the consumer will naturally vote with his dollars, choosing stronger companies if safety is his first priority, or favoring the higher risk companies if his primary concern is low cost and big benefits. Risk is not necessarily bad, provided it is properly disclosed to the consumer.

With these two changes, regulators would no longer have to face the impossible task of policing thousands of companies. Nor would there be a need for an expensive guarantee system. Rather, they could concentrate on enforcing full disclosure rules.

The best regulatory body in the world is the public. But to do their job efficiently, they need to have the facts.

APPENDIX A.—THE WEISS RATING SYSTEM

The Weiss Rating System is based upon a composite of five basic indexes, each of which have varying degrees of impact on the overall ratings. The descriptions which follow do not pretend to describe the system in its entirety or in all of its detail. However, they do provide critical insights to the logic used and the most important underlying assumptions made.

1. RISK-ADJUSTED CAPITAL

The most important measures used in the analysis of an individual company are our Risk-Adjusted Capital ratios (RACR) which have been useful tools in determining exposure to investment, liquidity and insurance risk in relation to the capital that the company has to cover those risks.

The first Risk-Adjusted Capital ratio evaluates the company's ability to withstand an average recession. The second evaluates the company's ability to withstand a severe recession.

An average recession is defined as a decline in real GNP of 10 percent, approximately equal to the average decline of postwar recessions between 1957 and 1982. A severe recession is defined as a decline in real GNP of 20 percent or more, or approximately half as severe as the Great Depression.

In order to calculate these capital ratios, we follow these steps:

Step 1. Capital Resources. We add up all of the company's resources which could be used to cover losses. These include capital, surplus and Mandatory Security Valuation Reserve (MSVR).

Step 2. Target Capital. Next, we determine the company's target capital. This answers the question: Based upon the company's level of risk in both its insurance business and its investment portfolio, how much capital would it need to cover potential losses during an average recession? In other words, we find out how much capital we believe this company should have (see Table 1, Appendix A).

Step 3. Risk-Adjusted Capital Ratio #1. We compare the results of step 1 with those of step 2. Specifically, we divide the "capital resources" by the "target capital" and express it in terms of a ratio. This ratio is the Risk-Adjusted Capital Ratio #1. Thus, if a company has a Risk-Adjusted Capital ratio of 1.0 or more, it means it has all of the capital we believe it requires to withstand the potential losses which could be inflicted by an average recession. If it has less than 1.0, it does not have all of the basic capital resources we think would be needed.

Assuming the company has a consistent record of profitable operations, it may also be able to cover losses from current earnings or by reducing dividends on participating policies before digging into capital resources. Additional capital may also be available from an affiliate or holding company. Therefore, an allowance is made in our program for firms with somewhat less than 1.0 Risk-Adjusted Capital ratios (see Table 2).

Step 4. Risk-Adjusted Capital Ratio #2. We repeat steps 2 and 3, but now assuming a severe recession.

HOW WE DETERMINE TARGET CAPITAL

The basic procedure for determining target capital is to ask these questions:

1. What is the breakdown of the company's investment portfolio and types of business?
2. For each category, what are the potential losses which could be incurred in the economic scenario and in light of potential liquidity problems?
3. In order to cover those potential losses, how much capital resources does the company need? It stands to reason that one needs more capital as a cushion for losses on high-risk investments, such as junk bonds, than one would need on low-risk investments, such as triple-A utility bonds.

However, it is also a fact that the same questions we have raised about traditional rating systems with respect to how they rate insurance companies can be asked about the way they rate bonds. The debt/equity ratios, quick ratios and other measures of financial health of industrial and utility firms receiving a high rating are generally much lower today than they were in the 1 950's or 1 960's, when the likelihood of adverse economic conditions was substantially less. Therefore, stricter capital requirements are needed to cover for this factor.

Table 1 shows target capital percentages used by Moody's Investment Services and the state insurance commissioners in relation to Weiss Risk-Adjusted Capital Ratios 1 and 2 (RACR #1 and RACK #2).

COMMENTS ON TARGET CAPITAL PERCENTAGES

The factors that are chiefly responsible for the conservative results of our Risk-Adjusted Capital ratios are the investment risks of bond classes 2–6, mortgages, real estate and affiliate common stock, as well as the interest rate risk for annuities. Comments on the basis of these figures are found below. Additional comments address factors that vary, based on particular performance or risk characteristics of the individual company.

Bonds. Target capital percentages for bonds are derived from a model which factors in historical cumulative bonds default rates from the last 20 years and the additional loss potential during a three-year recession. The continuance of post World War II prosperity is by no means a certainty. Realistic analysis of potential losses must factor in the possibility of severe economic reversal. Table 3 shows how this was done for each bond rating classification. A 15-year cumulative default rate is used, column 1, due to the 15-year average maturity at issue of bonds held by life insurance companies. These are historical default rates for 1970-1990 for each bond class, taken from a Moody's study entitled, Mood's Studies Loss Potential of Life Insurance Assets. In order to factor in the additional loss potential of a severe three-year long recession, we reduced the base to Moody's 12-year rate, as shown in column 2, determined the worst single year experience, column 3, extrapolated that experience over three years, column 4, and finally added the historical 12-year rate to the extrapolated 3-year projection to derive the Weiss 15-year default rate, columns.

The next step was to determine the losses that could be expected from these defaults. This would be equivalent to the capital a company should have to cover those losses. Loss rates were as signed for each bond class, column 6, based on the fact that higher rated issues generally carry less and better secured debt, leading to higher recovery rates upon default. Column 7 shows the loss rates that were used as a basis for the target capital percent for RACR #2 (Table 1, RACR #2 column, Bonds-classes 1 thru 6).

Recent changes in the way the investment loss reserve (MSVR) is calculated have not effected the reserving rate for bond classes 4 - 6 (formerly NO*, NO** and NO bonds). Rather, the commissioners have called on the states to limit junk bond investments through legislation.

This is an acknowledgement that the 10 percent and 20 percent figures used by State Insurance Commissioners (Table 1, SIC column, Bonds—classes 4, 5 and 6) is inadequate. If the figure accurately represented loss potential, there would be no need to limit holdings through legislation since an adequate reserve rate would require companies to have capital to absorb potential losses.

Mortgages. Mortgage default rates for the Risk-Adjusted Capital Ratios are derived from historical studies of mortgage and real estate losses in selected depressed markets. The rate for RACR #2 (Table 1, RACK #2 column, Mortgages-class 2) will vary between 2 percent - 20 percent, based on the performance of the company's mortgage portfolio in terms of mortgage loans 90 days past due, in process of foreclosure and foreclosed during the previous year.

Even the maximum 20 percent figure is by no means excessive and, in fact, may prove insufficient during a severe recession. The 2 percent mortgage rate used by Moody's (Table 1, Moody's column) assumes that market values on foreclosed properties, both residential and commercial, will remain stable even in the worst of times. However, a visit to the regions which have recently been subjected to real estate deflation should be sufficient to dissuade anyone from such an illusion. Many sellers are already taking losses of 50 cents on the dollar, and the full impact of the disposal of repossessed real estate by the Resolution Trust Corporation in the S&L bailout has yet to be felt.

Real Estate. The 33 percent rate (Table 1, RACK #2 column, Real Estate-class 2) used for potential real estate losses in the Weiss ratios is based on historical losses in depressed markets. It avoids the commonly made assumption that the continuous appreciation of property values experienced since World War II must inevitably continue.

Affiliate Common Stock. The target capital rate on affiliate common stock for RACR #2 can vary between 33 percent and 100 percent (Table 1, RACR #2 column, Common Stock stock—class 1) depending on the financial strength of the affiliate and the prospects for obtaining capital from the affiliate should the need arise.

Reinsurance. This factor varies with the quality of the reinsuring companies and the type of reinsurance being used (e.g. co-insurance, modified co-insurance, yearly renewable term, etc.).

Interest Rate Risk on Annuities. The 1 percent–5 percent rate on individual annuities (Table 1, RACR #2 column, Individual annuity reserves) and the 1 percent-3 percent rate for group annuities (Table 1, RACR #2 column, Group annuity reserves and GICs) are derived from studies of potential losses that can occur when assets and liabilities are not proxy matched. (See glossary under Asset/Liability matching.)

Companies are especially prone to losses in this area for one of two reasons: (1) They promise high interest rates on their annuities and have not locked in corresponding yields on their investments. If interest rates fall, the company will have difficulties earning the promised rate. (2) They lock in high returns on their investments, but allow policy surrenders without market value adjustments. If markets values decline and surrenders increase, liquidity problems can result in substantial losses.

The target capital figure used for each company is based on the surrender characteristics of their policies, the interest rate used in calculating reserves and the actuarial analysis found in New York Regulation 126 filing when available.

Spread of risk. A spread of risk factor, using size as a proxy for diversification, is also included in our RACRs. This factor increases target capital in the case of very small companies and reduces target capital in the case of the largest companies.

Tables 4 and 5 show the results of our RACR studies. In our view, many large companies have inadequate capital to deal with a truly adverse economic scenario.

2. FIVE-YEAR PROFITABILITY INDEX

We have developed a 5-Year Profitability Index (on a scale of zero to ten) which is a composite of five factors:

(a) gain or loss on operations by line of business
(b) consistency of operating results
(c) impact of operating results on surplus
(d) adequacy of investment income as compared to the needs of policy reserves
(e) expenses as a percent of revenues

The data from current and four prior years is weighted so that more recent data will have a greater impact on the index. Thus, the overall index is an indicator of the health of a company's current and past operations.

3. THE POLICY LEVERAGE INDEX

Based upon line of business, the Policy Leverage Index evaluates the degree to which a company has made commitments to its policyholders in proportion to its capital resources.

The statutory data breakdown by line of business includes the following categories: industrial life, ordinary life, individual annuities, supplementary contracts, credit life, group life, group annuities, group health, credit health and other health. In addition, when the data is made available to us by the companies, we are able to evaluate more detailed breakdowns with these additional categories: term life, variable life, variable annuities, disability and GICs.

These are weighted according to the capital resources we deem appropriate to support each line of business.

4. THE INVESTMENT SAFETY INDEX

This index has four components which examine exposure to:

(a) bond and mortgage defaults
(b) market value declines
(c) changes in interest rates
(d) "run" of redemptions on surrenderable policies

Default, market and interest rate risk are assessed by categories similar to those described above under Risk-Adjusted Capital Ratios.

Surrender exposure is measured by comparing total cash-out value of all surrenderable policies with the company's liquidity position.

5. THE STABILITY INDEX

With this index, we seek to identify companies that are currently experiencing problems or are at risk to develop problems in the short term. We employ an insolvency model that correlates instabilities found in a company's operations over the last three years. Factors included are the stability of gross and net income, stability of surplus, stability of investment mix, liquidity, exposure to surrenders, exposure to interest rate changes and numerous other factors.

HOW VARIOUS FACTORS IMPACT THE WEISS INSURANCE SAFETY RATING

The derivation of the final safety ratings is based on the premise that any one of a number of independent factors can cause an insurer to fail. Accordingly, the company must have a strong across-the-board performance in order to receive a strong rating. Conversely, a company need not be weak in all areas to get a weak rating.

Table 1.—Target Capital as a Percent of Assets

	Weiss RACR #1	Weiss RACR #2	Moody's July 1989	State Insurance Commissioners
Asset risk:				
Gov. guar. bonds	0	0	1	0
Bonds—class 1—investment grade bonds either rated AAA, AA or A by Moody's or S&P or deemed AAA-A equivalent by State insurance commissioners	0.5	1	0.5	1
Bonds—class 2—investment grade with some speculative elements, rated equivalent	2	5	1	2
Bonds—class 3—noninvestment grade bonds, BB rated or equivalent	5	15	2.5	5
Bonds—class 4—noninvestment grade bonds, B rated or equivalent	10	30	5	10
Bonds—class 5—noninvestment grade bonds, CCC, CC or C rated or equivalent	20	60	10	20
Bonds—class 6—noninvestment grade bonds, in or near default	20	60	10	20
Mortgages—class 1—mortgages guaranteed by VA, FHA or other Government agencies	.5	1	2	....
Mortgages—class 2—other mortgages in good standing	1–20	2–20	2	....
Mortgages—class 3—mortgages 90 days past due, in foreclosure and foreclosed during past year	25	33	....	....
Real estate—class 1—properties acquired in satisfaction of debt	20	50	5	....
Real estate—class 2—company occupied and other investment properties	10	33	5	....
Preferred stock—class 1—preferred stock in good standing and sinking fund	5	5	2.5	5
Preferred stock—class 2—preferred stock, not in good standing	20	20	....	20
Common stock—class 1—nonaffiliated common stock	25	33	25	33
Common stock—class 2—other common stock	25–100	33–100	100	20
Short-term investments	.5	1	1	
Policy loans	2	5	....	....
Premium notes	2	5	....	....
Collateral loans	2	5	....	....
Other invested assets	5	10	5	....
Insurance risk:				
Expected death claims	25	25	25	....
Individual health premiums	25	25	25	....
Group health premiums	10	15	10	....
Reinsurance	1–5	2–10	1	....
Interest rate risk:				
Life reserves	1–2	1–3	2	....
Individual annuity reserves	1–3	1–5	3	....
Group annuity reserves and GICs	1–2	1–3	1	....

Table 2.—Critical Ranges in Most Important Insurance Indexes

	Strong	Good	Fair	Weak
Risk Adjust Capital Ratio #1		1.0 or more	0.75–0.99	0.5–0.74
Risk Adjusted Capital Ratio #2	1.0 or more	0.75–0.99	0.5–0.74	0.49 or less
5 Year Profitability Index	7–10	5–6.9	3–4.9	2.9 or less

Table 2.—Critical Ranges in Most Important Insurance Indexes—Continued

	Strong	Good	Fair	Weak
Policy Leverage Index	7–10	5–6.9	3–4.9	2.9 or less
Investment Safety Index	7–10	5–6.9	3–4.9	2.9 or less
Stability Index	7–10	5–6.9	3–4.9	2.9 or less

Table 3.—Bond Default Rates—Potential Losses as A Percent of Bond Portfolio

	Moody's 15-year rate	Moody's 12-year rate	Moody's worst year	3 cumulative poor years	Weiss 15-year rate
Aaa	2.80	1.60	0.10	1.30	1.89
Aa	2.00	1.60	0.20	0.60	2.19
A	3.30	2.50	0.40	1.20	3.67
Baa	7.20	5.50	1.10	3.26	8.58
Ba	20.10	17.90	8.40	23.08	36.47
B	33.70	32.50	21.60	50.80	62.24

Table 4.—Large Companies With Insufficient Risk-Adjusted Capital

Company	Moody's risk-adjusted capital ratio	Weiss RACR #1 average recession	Weiss RACR #2 severe recession
Prudential Insurance Co. of America	.91	.91	.56
Metropolitan Life Insurance Co	.87	1.10	.68
Equitable Life ASR Soc. of the United States	.58	.64	.33
Aetna Life Insurance Co	1.05	1.13	.56
New York Life Insurance Co	1.24	1.28	.84
Connecticut General Life Insurance Co	1.36	1.37	.70
Travelers Insurance Co. Life Department	1.09	1.10	.30
Northwestern Mutual Life Insurance Co	1.25	1.10	.69
Teachers Insurance & Annuity Association of America	N/A	.65	.40
John Hancock Mutual Life Insurance Co	.82	.86	.46

Table 5.—Large Companies With Sufficient Risk-Adjusted Capital

Company	Moody's risk-adjusted capital ratio	Weiss RACR #1 average recession	Weiss RACR #2 severe recession
Continental Assurance Co	1.52	1.69	1.29
Jefferson Pilot Life Insurance Co	N/A	2.75	1.99

Appendix B. Low-Quality Bond Holdings Of U.S. Life And Health Insurance Companies

(companies with admitted assets of $100 million or more)

COMPANY	STATE	JUNK[1] BONDS/ INVESTED ASSETS	BBB[2] BONDS/ INVESTED ASSETS	JUNK+ BBB/ INVESTED ASSETS	INVESTED ASSETS	ADMITTED ASSETS
LINCOLN LIBERTY LIFE INS CO	NE	71.0	0.7	71.6	117,762,557	126,296,733
EXECUTIVE LIFE INS CO OF NEW YORK	NY	65.5	3.1	68.6	3,090,581,331	3,171,821,637
EXECUTIVE LIFE INS CO	CA	67.7	0.8	68.5	9,415,361,117	10,166,904,501
UNITED PACIFIC RELIANCE LIC OF NY	NY	24.4	40.7	65.1	617,202,309	630,710,209
UNITED PACIFIC LIFE INS CO	WA	32.1	31.9	64.0	5,406,197,744	5,558,037,728
PRESIDENTIAL LIFE INS CO	NY	56.0	8.7	64.7	2,280,942,405	2,335,525,446
COLONIAL PENN ANNUITY AND LIFE INS	DE	16.4	47.3	63.7	182,527,001	186,192,896
GUARANTEE SECURITY LIFE INS CO	FL	63.0	0.0	63.0	661,009,580	686,443,675
PAUL REVERE VARIABLE ANNUITY INS CO	MA	7.3	51.5	58.8	904,074,978	957,543,361
BALBOA LIFE INS CO	CA	10.2	41.7	51.9	213,201,139	226,364,773
INVESTORS EQUITY LIFE I C OF HI LTD	HI	30.5	19.6	50.1	147,252,445	151,401,621
CINCINNATI LIFE INS CO	OH	27.9	21.0	48.9	388,620,071	404,026,625
CALFARM LIFE INS CO	CA	21.0	27.3	48.3	476,310,258	491,203,769
FIRST CAPITAL LIFE INS CO	CA	40.7	7.1	47.8	3,946,686,076	4,458,167,450
NATIONAL INTEGRITY LIFE INS CO	NY	26.8	19.3	46.2	418,676,511	432,479,605
USLIFE LIFE INS CO	TX	10.0	36.1	46.1	459,036,044	474,522,414
OLD LINE LIFE INS CO OF AMERICA	WI	8.1	38.0	46.0	729,944,988	791,953,182
AMERICAN INVESTORS LIFE INS CO	KS	22.5	23.0	45.5	1,477,705,087	1,536,294,587
USG ANNUITY & LIFE CO	OK	14.0	31.5	45.5	1,539,063,517	1,569,900,223
UNITED STATES LIFE INS CO IN NYC	NY	12.6	32.7	45.3	1,092,080,961	1,175,176,499
OHIO LIFE INS CO	OH	30.0	14.9	44.9	286,132,562	296,171,518
OLD REPUBLIC LIFE INS CO OF NEW YOR	NY	12.3	31.2	43.5	111,068,535	117,946,444
PAUL REVERE PROTECTIVE LIFE INS CO	DE	9.5	33.9	43.4	420,714,742	435,054,040
FIDELITY BANKERS LIFE INS CO	VA	37.6	5.8	43.3	3,997,299,042	4,069,000,650
PAUL REVERE LIFE INS CO	MA	7.3	35.9	43.2	1,769,995,702	1,855,518,034
GENERAL SERVICES LIFE INS CO	LA	9.6	33.6	43.2	402,091,724	623,215,397
USLIFE CREDIT LIFE INS CO	IL	4.1	38.2	42.2	194,259,997	206,346,502
NORTH CENTRAL LIFE INS CO	MN	16.2	26.0	42.2	151,021,010	164,023,858
SECURITY OF AMERICA LIFE INS CO	PA	3.8	37.9	41.7	147,169,937	160,658,076
FIRST VARIABLE LIFE INS CO	AR	13.2	27.8	41.0	182,930,050	327,912,279
PACIFIC STANDARD LIFE INS CO	CA	35.5	5.0	40.5	548,601,571	565,924,166
SOVEREIGN LIFE INS CO OF CALIFORNIA	CA	6.7	33.7	40.3	272,574,278	290,331,431
PAN AMERICAN LIFE INS CO	LA	11.3	28.9	40.1	2,025,393,112	2,107,056,609
ACACIA NATIONAL LIFE INS CO	VA	13.1	27.0	40.1	286,035,935	301,231,462
FIRST GNA LIFE INS CO OF NEW YORK	NY	0.0	39.6	39.6	276,070,145	285,647,805
FEDERAL KEMPER LIFE ASSURANCE CO	IL	22.5	16.8	39.3	2,014,690,907	2,383,010,483
SAFECO LIFE INS CO	WA	9.9	29.1	39.0	5,234,457,799	5,373,117,152
CAPITOL LIFE INS CO	CO	25.5	13.2	38.7	1,347,667,216	1,418,197,794
LIFE REASSURANCE CORP OF AMERICA	CT	11.7	26.9	38.6	617,667,489	687,465,538
MARQUETTE NATIONAL LIFE INS CO	IL	29.9	8.2	38.0	767,755,290	906,590,092
JACKSON NATIONAL LIFE INS CO	MI	19.3	18.4	37.6	10,208,719,687	10,602,358,854
USAA LIFE INS CO	TX	7.1	30.5	37.5	1,297,700,701	1,353,389,754
PMF LIFE INS CO	FL	15.3	22.2	37.5	296,220,394	310,094,362
ROYAL TANDEM LIFE INS CO	NY	17.3	20.1	37.4	715,955,942	745,322,864
SUN LIFE INS CO OF AMERICA	MD	14.4	23.0	37.4	5,065,152,231	5,195,062,377
PHILADELPHIA AMERICAN LIFE INS CO	PA	15.0	22.4	37.3	53,653,551	122,903,622
AIG LIFE INS CO	PA	12.6	24.1	36.8	1,377,735,065	1,497,047,437
WESTERN RESERVE LIFE ASR CO OF OHIO	OH	26.5	10.1	36.6	438,026,195	618,767,660
KEMPER INVESTORS LIFE INS CO	IL	22.4	14.1	36.5	5,305,974,086	6,072,006,256
ALL AMERICAN LIFE INS CO	IL	4.4	31.1	35.5	1,019,506,098	1,062,258,648
TRANSAMERICA OCCIDENTAL LIC OF CA	CA	6.1	29.5	35.5	6,972,870,056	7,661,611,094
HOME LIFE FINANCIAL ASSURANCE CORP	FL	10.1	25.0	35.2	246,123,608	258,319,006
FIRST COLONY LIFE INS CO	VA	7.1	28.0	35.2	4,295,025,318	4,450,206,893
MONY LIFE INS CO OF AMERICA	AZ	12.1	22.8	34.9	1,167,702,001	1,274,213,044
SMA LIFE ASSURANCE CO	DE	6.4	28.3	34.7	1,010,206,130	2,020,374,000
WESTERN NATIONAL LIFE INS CO	TX	5.1	29.5	34.6	4,291,636,332	4,373,930,165
PROVIDENT LIFE & CAS INS CO	TN	3.7	30.8	34.4	179,511,076	202,275,882
IDS LIFE INS CO OF NEW YORK	NY	9.5	24.4	33.8	935,424,596	1,037,550,473
WASHINGTON SQUARE LIFE INS CO	PA	9.4	24.3	33.7	323,962,033	338,480,763
EQUITABLE LIFE INS CO OF IOWA	IA	13.7	19.9	33.7	1,597,574,688	1,701,944,826
MERRILL LYNCH LIFE INS CO	WA	7.1	26.6	33.6	3,353,710,637	3,803,011,270
NORTH ATLANTIC LIFE INS CO OF AM	NY	14.9	18.4	33.3	679,006,640	693,070,539
ANCHOR NATIONAL LIFE INS CO	CA	22.6	10.5	33.1	2,054,163,026	4,410,670,405
HAMILTON NATIONAL LIFE INS CO	MI	3.0	29.9	32.9	228,137,794	233,224,178
OLD AMERICAN INS CO	MO	20.3	12.6	32.9	112,543,056	130,401,149
INTEGRITY LIFE INS CO	AZ	14.9	18.0	32.9	1,278,208,203	1,332,330,847
WOODMEN ACCIDENT & LIFE CO	NE	4.2	28.6	32.8	461,274,861	477,460,255
MINNESOTA MUTUAL LIFE INS CO	MN	7.5	25.1	32.7	4,853,410,479	5,453,175,703
ERIE FAMILY LIFE INS CO	PA	16.1	16.5	32.6	195,940,502	203,896,216
CENTRAL LIFE ASSURANCE CO	IA	13.5	18.9	32.4	2,136,970,374	2,201,564,494
PHILADELPHIA LIFE INS CO	PA	20.4	12.0	32.4	1,285,360,077	1,325,938,276
PUBLIC SAVINGS LIFE INS CO	SC	1.8	30.5	32.3	179,675,392	192,024,840
LIFE INS CO OF VIRGINIA	VA	3.7	28.2	31.9	4,590,497,025	4,810,104,850
GLOBE LIFE INS CO	IL	4.3	27.4	31.8	753,601,737	788,989,930
AMERICAN INTL LIFE ASR CO OF NY	NY	11.6	19.9	31.5	2,142,907,685	2,229,069,034
GUARANTEE MUTUAL LIFE CO	NE	5.9	25.5	31.4	667,553,109	686,668,233
NORTHWESTERN NATIONAL LIFE	MN	16.9	14.4	31.3	4,402,276,810	4,908,637,257
USAA ANNUITY & LIFE INS CO	TX	5.2	26.0	31.2	1,645,371,064	1,673,744,724
MONARCH LIFE INS CO	MA	11.9	19.1	31.1	779,196,290	4,477,687,681
FBL INSURANCE CO	IA	8.7	22.1	30.7	470,891,670	484,219,701
COMMONWEALTH LIFE & ACCIDENT INS CO	MO	8.6	22.0	30.6	133,085,067	142,469,688
PRUCO LIFE INS CO	AZ	12.3	18.2	30.5	2,695,077,080	4,653,845,108
TANDEM INS GRP INC	IL	9.3	21.2	30.4	4,484,346,693	4,579,950,072
MBL LIFE ASSURANCE CORP	OH	9.6	20.8	30.3	190,208,094	194,479,134
GREAT AMERICAN LIFE INS CO	OH	12.3	17.6	29.8	3,718,344,462	3,781,129,783
VOLUNTEER STATE LIFE INS CO	TN	2.0	27.7	29.6	496,279,115	539,256,482
CM LIFE INS CO	CT	8.8	20.8	29.6	570,961,250	593,019,080
ACCELERATION LIFE INS CO	OH	3.6	25.9	29.5	105,577,508	112,571,947
KEYPORT LIFE INS CO	RI	11.1	18.4	29.5	6,946,340,927	7,341,011,694
COMPANION LIFE INS CO	NY	5.3	23.9	29.2	187,581,087	192,489,904
NORTHERN LIFE INS CO	WA	12.5	16.4	29.0	2,013,612,104	2,061,569,265
MINISTERS LIFE A MUTUAL LIFE INS CO	MN	11.0	17.9	28.9	213,686,909	224,563,173
XEROX FINANCIAL SERVICES LIFE	MO	11.1	17.7	28.8	2,659,618,978	2,792,038,206

COMPANY	STATE	JUNK[1] BONDS/ INVESTED ASSETS	BBB[2] BONDS/ INVESTED ASSETS	JUNK+ BBB/ INVESTED ASSETS	INVESTED ASSETS	ADMITTED ASSETS
COLONIAL LIFE INS CO OF AMERICA	NJ	1.9	26.8	28.7	532,977,019	556,058,951
ALLSTATE LIFE INS OF NEW YORK	NY	8.8	19.7	28.5	669,625,725	694,164,277
ACACIA MUTUAL LIFE INS CO	DC	5.8	22.5	28.4	769,684,161	813,130,644
GREAT AMERICAN RESERVE INS CO	TX	4.3	23.6	27.9	833,260,682	895,979,738
AMERICAN UNITED LIFE INS CO	IN	2.5	25.3	27.8	3,890,880,144	4,085,775,364
PRINCIPAL NATIONAL LIFE INS CO	IA	12.8	14.7	27.5	521,658,176	526,135,845
INA LIFE INS CO OF NEW YORK	NY	5.5	22.0	27.5	286,755,947	307,601,200
VERMONT LIFE INS CO	VT	1.0	26.4	27.4	336,490,662	356,351,605
AMERICAN MUTUAL LIFE INS CO	IA	9.0	18.2	27.2	848,248,508	873,285,715
TEACHERS INS. & ANN. ASSOC OF AM	NY	8.2	19.0	27.2	48,925,419,218	49,894,058,078
INVESTORS LIFE INS CO OF NEBRASKA	SD	2.2	25.0	27.1	162,249,593	179,576,414
ROYAL LIFE INS CO OF NEW YORK	NY	3.2	23.8	27.0	326,447,232	342,281,046
PRINCIPAL MUTUAL LIFE INS CO	IA	9.2	17.7	26.9	22,951,201,184	27,541,262,318
NORTH AMERICAN CO FOR LIFE & H INS	IL	20.9	5.9	26.8	1,992,618,646	2,073,023,571
AMERICAN MAYFLOWER LIFE INS CO OF N	NY	3.2	23.4	26.7	412,028,750	424,322,162
AMERICAN REPUBLIC INS CO	IA	1.2	25.3	26.6	290,764,936	408,100,381
FEDERATED LIFE INS CO	MN	3.5	23.1	26.6	294,722,321	301,827,495
ALLSTATE LIFE INS CO	IL	10.1	16.4	26.5	14,463,001,538	14,817,651,844
VICTORY LIFE INS CO	KS	9.6	16.8	26.4	335,220,389	346,668,264
IDS LIFE INS CO	MN	8.2	18.1	26.4	12,172,492,856	15,584,591,335
CONTINENTAL AMERICAN LIFE INS CO	DE	6.8	19.3	26.2	562,063,326	601,904,177
PRUDENTIAL INS CO OF AMERICA	NJ	9.9	16.1	26.0	103,180,861,842	133,456,033,093
SECURITY MUTUAL LIFE INS CO OF NY	NY	3.6	22.3	25.9	624,785,606	689,492,773
FIRST CONTINENTAL LIFE & ACC INS CO	UT	6.4	19.4	25.8	111,534,670	121,130,111
NATIONAL FIDELITY LIFE INS CO	MO	9.7	15.6	25.3	396,635,435	419,203,951
UNITED LIFE INS CO	IA	8.0	17.2	25.2	130,216,812	132,931,109
GUARANTY INCOME LIFE INS CO	LA	3.4	21.8	25.2	110,632,029	113,308,721
LAFAYETTE LIFE INS CO	IN	1.2	23.8	25.0	444,115,804	463,844,861
INTER-STATE ASSURANCE CO	IA	2.2	22.8	25.0	170,397,867	175,151,751
ALEXANDER HAMILTON LIFE OF AM	MI	12.9	12.0	24.9	3,758,985,935	3,844,121,227
FRANKLIN LIFE INS CO	IL	3.5	21.4	24.8	4,369,703,385	4,593,362,379
PIONEER MUTUAL LIFE INS CO	ND	8.7	16.1	24.8	219,323,162	227,671,174
BANNER LIFE INS CO	MD	6.1	18.6	24.7	435,702,918	503,197,871
EMPLOYERS LIFE INS CO OF WAUSAU	WI	4.8	19.8	24.6	666,324,137	758,860,541
ACADEMY LIFE INS CO	CO	1.0	23.6	24.6	254,790,565	299,639,587
OHIO NATIONAL LIFE INS CO	OH	4.4	20.2	24.6	2,481,377,605	2,641,488,439
EQUITABLE VARIABLE LIFE INS CO	NY	9.1	15.4	24.5	7,316,354,487	9,525,616,950
LIFE INS CO OF NORTH AMERICA	PA	9.8	14.5	24.3	1,719,356,051	2,032,581,964
UNITED PRESIDENTIAL LIFE INS CO	IN	8.9	15.4	24.3	591,074,996	603,355,896
TRANSAMERICA LIFE INS & ANNUITY CO	CA	6.1	18.1	24.2	7,819,039,238	8,433,438,769
MUTUAL LIFE INS CO OF NEW YORK	NY	9.7	14.4	24.1	14,020,989,979	17,995,935,324
CHUBB LIFE INS CO OF AMERICA	NH	2.4	21.6	24.0	668,910,940	756,626,681
BANKERS LIFE AND CASUALTY CO OF NY	NY	10.8	13.1	23.9	141,810,477	145,894,565
FARM FAMILY LIFE INS CO	NY	8.3	15.5	23.8	401,781,471	413,295,576
SENTRY LIFE INS CO	WI	2.1	21.6	23.7	836,036,607	1,112,767,856
AMERICAN GENERAL LIFE INS CO OF NY	NY	4.1	19.5	23.6	502,770,615	536,621,011
KENTUCKY CENTRAL LIFE INS CO	KY	4.1	19.4	23.6	1,206,964,533	1,322,854,691
GROUPAMERICA INS CO	CT	3.3	20.2	23.5	122,259,893	130,823,253
PROVIDENT LIFE & ACCIDENT INS CO	TN	3.2	20.2	23.3	4,597,579,565	4,925,131,100
UNUM LIFE INS CO	ME	3.6	19.6	23.2	4,244,409,013	4,484,914,440
MML PENSION INS CO	DE	1.7	21.5	23.2	243,714,741	247,045,578
CERTIFIED LIFE INS CO	CA	12.1	11.0	23.1	115,772,357	119,562,771
STATE MUTUAL LIFE ASR CO OF AM	MA	3.6	19.5	23.1	5,533,358,273	6,103,538,642
JOHN HANCOCK VARIABLE LIFE INS CO	MA	4.6	18.3	22.9	598,957,202	1,773,098,009
CONTINENTAL WESTERN LIFE INS CO	IA	0.1	22.7	22.8	253,697,467	260,124,055
PENN INS & ANNUITY CO	DE	8.3	14.5	22.8	577,838,532	592,891,276
SUN LIFE INS & ANNUITY CO OF NY	NY	1.0	21.9	22.8	210,100,794	352,283,333
OHIO NATIONAL LIFE ASR CORP	OH	9.7	13.1	22.8	256,309,138	267,392,399
NATIONAL HERITAGE INS CO	TX	0.5	22.2	22.7	550,268,908	604,265,411
METROPOLITAN INS & ANNUITY CO	DE	1.8	20.8	22.5	3,447,866,962	3,502,673,835
SOUTHLAND LIFE INS CO	TX	4.5	17.8	22.3	934,445,742	971,959,900
GUARANTEE RESERVE LIFE INS CO	IN	4.1	18.1	22.3	89,311,993	101,836,120
UNION BANKERS INS CO	TX	12.1	10.2	22.3	176,200,540	182,976,974
GREAT NORTHERN INSURED ANNUITY CORP	WA	1.6	20.6	22.2	3,693,311,296	3,772,561,544
UNITY MUTUAL LIFE INS CO	NY	5.1	17.1	22.2	562,702,536	579,492,981
JOHN HANCOCK MUTUAL LIFE INS CO	MA	6.3	16.0	22.2	28,699,029,277	33,749,544,772
NATIONAL WESTERN LIFE INS CO	CO	7.0	15.1	22.1	1,850,159,884	1,889,306,690
STATE LIFE INS CO	IN	2.3	19.7	22.1	203,492,994	211,648,448
UNITED COMPANIES LIFE INS CO	LA	7.6	14.4	22.0	1,030,899,931	1,075,243,381
UTICA NATIONAL LIFE INS CO	NY	3.4	18.7	22.0	100,129,690	102,259,880
PENN MUTUAL LIFE INS CO	PA	5.1	16.9	22.0	5,366,685,431	5,759,954,709
WESTERN SOUTHERN LIFE ASR CO	OH	4.2	17.8	22.0	810,738,084	835,763,768
HOME LIFE INS CO	NY	6.0	16.0	21.9	4,223,638,388	4,405,310,780
UNUM PENSION AND INS CO	ME	3.4	18.5	21.9	714,472,308	734,191,111
NATIONAL LIFE INS CO	VT	4.3	17.6	21.9	3,686,338,099	4,043,312,927
WILLIAM PENN LIFE INS CO OF NY	NY	3.2	18.7	21.8	656,575,407	682,736,035
MASSACHUSETTS MUTUAL LIFE INS CO	MA	6.6	15.1	21.7	23,870,234,278	27,228,729,007
PRUCO LIFE INS CO OF NEW JERSEY	NJ	1.2	20.5	21.7	595,071,392	1,018,407,969
PACIFIC FIDELITY LIFE INS CO	CA	9.3	12.4	21.6	874,069,102	1,078,053,175
CONNECTICUT GENERAL LIFE INS CO	CT	8.2	13.2	21.4	34,711,305,213	37,407,343,542
FIDELITY SECURITY LIFE INS CO	MO	6.0	15.4	21.4	192,474,330	204,269,952
CONNECTICUT MUTUAL LIFE INS CO	CT	6.4	15.0	21.4	9,721,360,058	11,132,911,011
BANKERS UNITED LIFE ASSURANCE CO	IA	8.2	13.1	21.3	598,007,463	636,045,063
STATE MUTUAL INS CO	GA	6.8	14.4	21.2	201,116,871	215,511,160
SOUTHERN FARM BUREAU ANNUITY INS CO	MS	6.4	14.7	21.1	794,073,746	817,342,970
FIDELITY LIFE ASN	IL	9.7	11.4	21.1	266,415,695	284,318,793
FARM BUREAU LIFE INS CO	IA	6.0	15.1	21.0	805,841,899	842,544,192
MANHATTAN LIFE INS CO	NY	6.0	14.9	21.0	485,932,364	501,371,481
NATIONWIDE LIFE INS CO	OH	2.7	18.3	20.9	8,909,549,605	12,337,304,051
UNUM LIFE INS CO OF AMERICA	ME	3.2	17.7	20.9	2,580,432,589	2,686,009,007
AMERICAN INCOME LIFE INS CO	IN	15.2	5.6	20.9	363,013,238	399,326,581
NATIONAL TRAVELERS LIFE CO	IA	3.2	17.5	20.8	314,780,128	322,605,101
CENTURY LIFE OF AMERICA	IA	5.5	15.2	20.7	1,564,916,813	1,640,192,626
OCCIDENTAL LIFE INS CO OF NC	NC	10.4	2.3	20.6	187,049,087	204,466,305
AMERICAN-AMICABLE LIFE INS CO OF TX	TX	0.0	20.4	20.4	103,134,637	109,672,604
RELIANCE STANDARD LIFE INS CO OF TX	TX	20.3	0.0	20.3	125,013,709	129,239,783

COMPANY	STATE	JUNK[1] BONDS/ INVESTED ASSETS	BBB[2] BONDS/ INVESTED ASSETS	JUNK+ BBB/ INVESTED ASSETS	INVESTED ASSETS	ADMITTED ASSETS
BENEFICIAL STANDARD LIFE INS CO	CA	5.3	14.7	20.1	1,012,209,089	1,062,512,976
MANHATTAN NATIONAL LIFE INS CO	MD	6.5	13.6	20.0	184,288,407	200,762,903
FIRST UNUM LIFE INS CO	NY	1.9	18.1	20.0	462,369,757	485,543,667
LIFE INS CO OF THE SOUTHWEST	TX	6.1	13.8	19.9	961,160,795	900,035,309
MUTUAL SERVICE LIFE INS CO	MN	5.9	13.9	19.8	432,204,507	482,023,472
COMMONWEALTH LIFE INS CO	KY	2.8	17.0	19.8	4,116,177,631	4,580,750,776
GULF LIFE INS CO	FL	6.0	13.8	19.7	1,264,330,827	1,322,330,396
MERIT LIFE INS CO	IN	2.9	16.9	19.7	484,536,736	804,226,107
UNITED OF OMAHA LIFE INS CO	NE	3.4	16.3	19.7	4,167,280,474	4,366,210,358
BANKERS NATIONAL LIFE INS CO	TX	7.1	12.5	19.6	1,067,433,271	1,181,559,142
MASSACHUSETTS GENERAL LIFE INS CO	MA	8.1	11.5	19.6	613,078,905	651,657,679
LINCOLN INCOME LIFE INS CO	KY	9.2	10.5	19.6	236,186,456	304,369,377
AMERICAN FOUNDERS LIFE INS CO	TX	13.9	5.7	19.6	283,587,141	294,071,900
PREFERRED RISK LIFE INS CO	CO	8.6	10.8	19.4	162,975,422	170,895,155
JOHN DEERE LIFE INS CO	IL	2.6	16.8	19.4	300,304,709	307,699,616
CALIFORNIA WESTERN STATES LIFE IN C	CA	5.8	13.6	19.4	753,697,924	810,508,475
SECURITY CONNECTICUT LIFE INS CO	CT	6.6	12.7	19.3	855,466,636	893,365,602
HARVEST LIFE INS CO	OH	7.8	11.3	19.1	392,625,668	408,131,665
MIDLAND NATIONAL LIFE INS CO	SD	3.2	15.9	19.1	1,062,612,377	1,120,861,790
SECURITY MUTUAL L I C OF LINCOLN NE	NE	3.6	15.4	19.0	280,924,065	289,821,815
STANDARD LIFE & ACCIDENT INS CO	OK	3.3	15.7	18.9	243,458,832	257,311,870
LIFE INVESTORS INS CO OF AMERICA	IA	8.5	10.4	18.9	2,156,017,926	2,214,753,589
CONSTITUTION LIFE INS CO	IL	5.6	13.3	18.9	1,039,363,333	1,056,643,932
PROVIDENT MUTUAL LIFE I C OF PHILAD	PA	4.5	14.2	18.7	2,113,466,197	2,936,786,906
INDIANAPOLIS LIFE INS CO	IN	2.1	16.6	18.6	940,259,927	983,572,301
NN INVESTORS LIFE INS CO INC	IA	3.2	15.0	18.1	527,994,260	556,616,157
UNION CENTRAL LIFE INS CO	OH	2.9	15.1	18.0	2,858,340,600	3,075,574,475
COMMERCIAL UNION LIFE INS CO OF AM	DE	4.3	13.6	17.9	530,396,562	552,028,627
AMERICAN ENTERPRISE LIFE INS CO	IN	3.4	14.5	17.9	542,742,144	551,069,656
PACIFIC MUTUAL LIFE INS CO	CA	4.8	13.1	17.9	8,713,624,362	9,783,343,070
FIRST PENN-PACIFIC LIFE INS CO	PA	2.1	15.8	17.9	541,409,039	552,238,952
AMICA LIFE INS CO	RI	2.2	15.7	17.9	138,110,312	146,180,146
AMERICAN STATES LIFE INS CO	IN	1.6	16.2	17.9	249,570,833	265,757,039
VALLEY FORGE LIFE INS CO	PA	5.7	12.2	17.9	305,718,566	359,461,353
COMBINED LIFE INS CO OF NEW YORK	NY	1.3	16.5	17.8	208,606,189	216,392,280
MONUMENTAL LIFE INS CO	MD	5.0	12.8	17.8	1,401,455,244	1,485,897,373
GEORGIA INTERNATIONAL LIFE INS CO	GA	4.5	13.2	17.7	217,415,895	224,610,696
NATIONAL HEALTH INS CO	TX	0.6	17.1	17.6	112,788,565	122,842,506
PROVIDENT LIFE INS CO	ND	3.9	13.6	17.6	169,857,873	178,174,158
HORACE MANN LIFE INS CO	IL	9.5	8.0	17.6	1,561,402,172	1,747,867,441
TRAVELERS LIFE INS CO	CT	5.6	11.9	17.5	1,020,318,077	1,047,623,931
EXECUTIVE FUND LIFE INS CO	NE	6.3	11.2	17.4	77,663,089	106,529,411
BANKERS LIFE & CAS CO	IL	9.5	7.9	17.4	1,187,702,701	1,375,586,534
COMMERCIAL LIFE INS CO	WI	0.0	17.3	17.3	283,600,940	315,387,418
BANKERS SECURITY LIFE INS SOCIETY	NY	3.9	13.3	17.2	359,949,793	511,350,658
PROVIDENT NATIONAL ASR CO	TN	2.4	14.7	17.1	7,667,294,223	7,907,635,269
OLD REPUBLIC LIFE INS CO	IL	5.5	11.6	17.0	109,484,550	114,672,865
AUSA LIFE INS CO	IA	5.3	11.7	17.0	2,148,148,608	2,181,372,394
EQUITABLE LIFE INS CO	VA	5.1	11.8	16.9	405,592,547	422,500,008
NATIONAL HOME LIFE ASSURANCE CO	MO	2.1	14.4	16.6	4,921,698,022	5,326,968,529
ALFA LIFE INS CORPORATION	AL	3.3	13.1	16.5	248,921,955	327,315,493
MIDWESTERN UNITED LIFE INS CO	IN	2.1	14.3	16.4	256,633,057	262,278,991
FIDELITY & GUARANTY LIFE INS CO	MD	13.0	3.3	16.3	4,246,029,846	4,428,850,635
FARMERS & TRADERS LIFE INS CO	NY	3.4	12.8	16.2	181,659,383	188,109,592
ROYAL LIFE INS CO OF AMERICA	CT	3.4	12.8	16.2	172,124,068	180,957,004
GENERAL AMERICAN LIFE INS CO	MO	3.9	12.3	16.2	5,100,086,598	6,052,440,603
EQUITABLE LIFE ASR SOC OF THE US	NY	7.7	8.4	16.1	34,787,900,254	50,301,568,564
SUNSET LIFE INS CO OF AMERICA	WA	1.0	15.1	16.1	289,281,317	296,024,301
MONUMENTAL GENERAL INS CO	MD	3.8	12.3	16.1	188,193,765	237,567,806
BRADFORD NATIONAL LIFE INS CO	KY	11.0	5.0	16.1	206,002,430	213,587,139
WASHINGTON NATIONAL INS CO	IL	8.8	7.2	16.0	1,618,708,980	1,711,132,836
INTERFAITH LIFE INS CO	PA	3.9	12.1	16.0	122,117,085	126,461,996
VARIABLE ANNUITY LIFE INS CO	TX	1.9	14.1	16.0	11,486,173,699	12,461,123,363
LAMAR LIFE INS CO	MS	11.1	4.9	16.0	402,829,612	422,239,354
CANADA LIFE INS CO OF NEW YORK	NY	4.6	11.4	16.0	137,409,174	140,631,898
CREDIT LIFE INS CO	OH	7.4	8.5	15.9	158,819,175	205,546,933
MIDLAND MUTUAL LIFE INS CO	OH	1.9	14.0	15.9	906,434,443	939,137,160
LIFE & CASUALTY INS CO OF TENNESSEE	TN	3.5	12.4	15.9	1,398,551,218	1,470,648,244
AMERICAN GENERAL LIFE INS CO	TX	4.9	10.9	15.8	1,820,309,580	1,881,730,719
METLIFE SECURITY INS CO OF LOUISIAN	LA	0.9	14.9	15.8	521,692,972	533,716,930
FIRST ALEXANDER HAMILTON LIFE INS C	NY	0.2	15.5	15.8	117,741,082	120,327,625
AETNA LIFE INS CO OF ILLINOIS	IL	4.1	11.5	15.6	102,074,758	109,243,638
NEW YORK LIFE INS & ANNUITY CORP	DE	3.9	11.8	15.6	9,963,628,334	10,506,751,155
AMERICAN GENERAL LIFE INS CO OF DE	DE	2.9	12.7	15.5	1,079,230,710	1,171,692,639
NEW YORK LIFE INS CO	NY	3.5	11.9	15.5	37,249,702,696	39,876,334,230
FIRST EQUICOR LIFE INS CO	CA	0.0	15.4	15.4	92,784,039	113,815,344
LINCOLN NATIONAL LIFE INS CO	IN	4.2	11.1	15.4	14,174,192,951	18,788,759,984
GOVERNMENT PERSONNEL MUTUAL L INS C	TX	2.3	12.9	15.2	327,910,339	341,406,711
GUARDIAN LIFE INS CO OF AMERICA	NY	3.5	11.7	15.2	5,566,339,937	6,159,653,708
CONNECTICUT NATIONAL LIFE INS CO	NJ	4.3	10.8	15.1	345,796,733	360,708,655
AMERICAN LIFE AND CASUALTY INS CO	IA	9.4	5.4	14.8	2,224,284,181	2,288,277,378
UNITED FARM BUR FAMILY LIFE INS CO	IN	0.4	14.3	14.6	613,008,596	643,474,379
WASHINGTON NATIONAL LIFE INS C OF N	NY	6.2	8.4	14.6	172,305,450	181,362,193
UNITED FAMILY LIFE INS CO	GA	0.4	14.2	14.6	328,147,624	347,183,068
CROWN AMERICA LIFE INS CO	KY	2.7	11.9	14.5	386,709,308	541,099,094
CHARTER NATIONAL LIFE INS CO	MO	4.1	10.4	14.5	999,591,573	1,114,613,034
MASSACHUSETTS CASUALTY INS CO	MA	1.4	13.1	14.4	121,308,448	124,339,698
AMERICAN GENERAL LIFE & ACC INS CO	TN	5.0	9.4	14.4	3,537,745,491	3,707,343,931
LIFE OF MARYLAND INC	MD	1.8	12.5	14.4	147,289,901	152,233,717
TRAVELERS LIFE & ANNUITY CO	CT	4.9	9.5	14.3	3,726,617,514	3,791,549,465
NEW ENGLAND MUTUAL LIFE INS CO	MA	6.2	8.2	14.3	12,396,275,421	17,123,279,177
FEDERAL LIFE INS CO (MUTUAL)	IL	2.4	11.9	14.3	144,133,117	175,968,961
AETNA LIFE INS CO	CT	2.8	11.5	14.3	38,553,850,449	52,342,635,960
SOUTHWESTERN LIFE INS CO	TX	3.5	10.8	14.3	1,261,926,995	1,354,718,014
VETERANS LIFE INS CO	IL	7.4	6.9	14.3	167,956,587	197,346,218
PHOENIX MUTUAL LIFE INS CO	CT	4.3	9.8	14.1	4,939,597,127	6,391,304,428

COMPANY	STATE	JUNK[1] BONDS/ INVESTED ASSETS	BBB[2] BONDS/ INVESTED ASSETS	JUNK+ BBB/ INVESTED ASSETS	INVESTED ASSETS	ADMITTED ASSETS
SECURITY BENEFIT LIFE INS CO	KS	4.4	3.4	7.8	1,741,424,395	2,397,812,686
BENEFIT TRUST LIFE INS CO	IL	2.0	5.8	7.8	313,074,051	347,649,340
ILLINOIS MUTUAL LIFE & CASUALTY CO	IL	1.6	6.2	7.8	314,393,876	332,364,068
UNITED FIDELITY LIFE INS CO	TX	3.0	4.7	7.7	332,179,134	366,336,406
CUMIS LIFE INS INC	WI	2.4	5.2	7.6	174,176,473	191,551,027
CENTRAL NATIONAL LIFE IN CO OF OMAH	NE	1.3	6.2	7.6	496,237,149	558,551,253
COLOGNE LIFE REINSURANCE CO	CT	3.2	4.4	7.5	227,554,839	307,101,780
SECURITY INDUSTRIAL INS CO	LA	1.7	5.8	7.5	161,981,660	166,927,094
GREAT SOUTHERN LIFE INS CO	TX	1.4	6.0	7.3	662,053,050	686,975,577
ITT LIFE INS CORP	MN	0.0	7.1	7.1	348,707,819	361,775,105
KANSAS FARM BUREAU LIFE INS CO INC	KS	2.0	5.1	7.1	225,929,697	237,035,615
INTER-AMERICAN INS CO OF IL	IL	6.4	0.6	7.1	102,354,662	139,567,004
NEW ENGLAND VARIABLE LIFE INS CO	DE	0.0	7.0	7.0	53,405,058	161,709,032
GOLDEN STATE MUTUAL LIFE INS CO	CA	1.2	5.7	6.9	100,895,534	117,723,038
COLLEGE LIFE INS CO OF AMERICA	IN	0.5	6.4	6.9	197,334,833	203,936,492
EDUCATORS MUTUAL LIFE INS CO	PA	1.2	5.7	6.9	119,791,166	126,715,843
UNITED INVESTORS LIFE INS CO	MO	4.9	1.9	6.8	494,450,800	599,504,603
EMPLOYERS HEALTH INS CO	WI	0.6	6.2	6.8	378,558,075	428,419,339
HOME BENEFICIAL LIFE INS CO	VA	2.9	3.7	6.6	1,050,922,333	1,091,138,776
STATE FARM LIFE & ACCIDENT ASR CO	IL	0.6	6.0	6.6	373,300,063	386,927,206
OHIO STATE LIFE INS CO	OH	1.9	4.7	6.6	532,570,960	544,214,404
FARMERS NEW WORLD LIFE INS CO	WA	1.3	5.2	6.5	1,618,419,322	2,130,168,484
AETNA LIFE INS & ANNUITY CO	CT	1.3	5.2	6.5	7,208,181,478	11,267,623,990
INVESTORS HERITAGE LIFE INS CO	KY	0.6	5.9	6.5	119,612,330	125,795,903
KANAWHA INS CO	SC	3.7	2.6	6.4	103,937,462	118,974,331
AMERICAN LIFE INS CO OF NEW YORK	NY	0.3	6.0	6.3	748,486,975	782,361,408
WESTERN STATES LIFE INS CO	ND	3.3	2.9	6.2	540,044,799	549,023,139
PHOENIX AMERICAN LIFE INS CO	DE	0.5	5.6	6.2	169,006,846	175,888,152
WESTERN UNITED LIFE ASR CO	WA	2.5	3.6	6.1	442,965,596	470,565,952
ARISTAR LIFE INS CO	UT	1.4	4.7	6.1	183,000,715	187,521,069
AMERICAN FIDELITY ASR CO	OK	0.5	5.6	6.1	568,970,605	639,160,653
FIRST STRATFORD LIFE INS CO	DE	6.0	0.0	6.0	380,590,175	411,474,218
STATE FARM LIFE INS CO	IL	1.2	4.7	5.9	11,746,698,158	12,132,288,408
CHARTERED PROTECTIVE LIFE INS CO	CA	2.4	3.5	5.8	100,865,558	107,763,013
EMPLOYERS REASSURANCE CORP	KS	1.6	4.2	5.8	1,002,130,319	1,214,163,565
FIDELITY MUTUAL LIFE INS CO	PA	0.0	5.6	5.7	1,141,670,789	1,236,568,206
WESTERN & SOUTHERN LIFE INS CO	OH	0.7	4.8	5.6	3,056,661,289	3,582,770,968
DESERET MUTUAL INS CO	UT	1.8	3.7	5.5	16,335,096	1,042,200,762
FORT DEARBORN LIFE INS CO	IL	0.0	5.4	5.5	110,445,842	123,322,613
AMERICAN CENTURION LIFE & ACC ASR C	CA	2.6	2.8	5.4	392,539,871	417,229,454
NORTH AMERICAN SECURITY LIFE INS CO	DE	0.9	4.4	5.4	209,735,659	1,090,137,979
PENNSYLVANIA NATIONAL LIFE INS CO	PA	0.2	5.1	5.3	114,079,051	117,907,119
MACCABEES LIFE & ANNUITY CO	MI	0.0	5.2	5.2	173,539,370	181,309,002
SIERRA-GENERAL LIFE INS CO	NV	0.0	5.0	5.0	75,305,734	173,657,004
STANDARD LIFE INS CO	MS	0.7	4.4	5.0	144,565,928	146,963,368
STANDARD INS CO	OR	0.8	4.2	4.9	2,053,216,271	2,134,343,708
SOUTHERN LIFE & HEALTH INS CO	DE	4.8	0.1	4.9	184,191,493	193,047,106
ASSOCIATION LIFE INS CO INC	WI	2.6	2.2	4.8	157,168,642	163,509,298
WABASH LIFE INS CO	IN	1.0	3.6	4.7	323,479,898	334,379,151
UNITED AMERICAN INS CO	DE	3.0	1.5	4.5	618,065,686	639,560,623
MASSACHUSETTS IND & LIFE INS CO	MA	0.6	3.7	4.3	1,138,792,644	1,357,204,366
AMERICAN LIFE & ACC INS CO OF KY	KY	0.4	3.7	4.1	130,480,204	131,940,066
FIDELITY UNION LIFE INS CO	TX	0.8	3.2	4.0	784,317,163	806,843,506
CENTRAL STATES H & L CO OF OMAHA	NE	0.2	3.7	3.9	122,381,350	132,554,636
LYNDON INS CO	WI	0.2	3.7	3.9	770,604,190	1,072,479,110
INDEPENDENT LIFE & ACCIDENT INS CO	FL	1.7	2.0	3.7	993,804,714	1,031,347,247
WORLD INS CO	NE	0.2	3.4	3.5	109,046,680	113,703,019
HARTFORD LIFE & ACCIDENT INS CO	CT	0.3	3.1	3.4	1,648,532,95[illegible]	1,856,274,290
JOHN ALDEN LIFE INS CO	NY	0.7	2.7	3.4	551,482,238	564,072,339
LIBERTY NATIONAL LIFE INS CO	AL	2.1	1.3	3.3	2,165,209,651	2,202,266,693
SETTLERS LIFE INS CO	VA	2.0	1.3	3.3	106,020,107	109,271,253
HARTFORD LIFE INS CO	CT	0.0	3.2	3.3	6,877,660,609	11,615,264,050
CELTIC LIFE INS CO	RI	0.0	3.2	3.2	119,502,248	136,870,759
UNITED GROUP INS CO	TX	0.4	2.7	3.1	107,363,632	113,866,612
COMMERCIAL BANKERS LIFE INS CO	CA	0.5	2.6	3.1	106,651,959	111,144,474
RELIABLE LIFE INS CO	MO	0.0	3.1	3.1	355,070,606	382,209,296
HEALTH CARE SERVICE CORP (MUTUAL)	IL	0.6	2.5	3.1	667,789,588	796,009,034
NORTH AMERICAN LIFE & CAS	MN	0.2	2.9	3.0	790,109,891	1,269,004,552
OXFORD LIFE INS CO	AZ	0.9	2.2	3.0	319,449,033	337,570,456
NATIONAL LIBERTY LIFE INS CO	PA	0.2	2.6	2.8	216,717,274	230,378,111
AUTO-OWNERS LIFE INS CO	MI	1.4	1.4	2.8	334,712,290	343,131,326
NORTH AMERICAN REASSURANCE CO	NY	1.0	1.7	2.7	494,930,915	644,323,711
GLOBE LIFE AND ACCIDENT INS CO	DE	2.4	0.2	2.6	613,047,839	654,003,620
CONSUMERS LIFE INS CO	DE	0.7	1.7	2.5	82,640,955	107,195,351
UNIVERSAL UNDERWRITERS LIFE INS CO	MO	0.2	2.2	2.4	135,516,739	142,629,574
BLUE CROSS/BLUE SHIELD OF FL	FL	0.0	2.3	2.3	358,599,779	625,246,762
MAINE FIDELITY LIFE INS CO	ME	0.2	2.1	2.3	442,295,042	455,260,329
BLUE CROSS & BLUE SHIELD OF KY INC	KY	0.0	2.3	2.3	247,660,859	347,809,455
GROUP LIFE & HEALTH INS CO	TX	1.2	1.0	2.2	102,295,403	137,628,634
AMOCO LIFE INS CO	NE	0.1	2.0	2.1	310,742,847	326,853,950
PEKIN LIFE INS CO	IL	0.4	1.6	2.0	197,581,218	203,691,085
STATE BOND & MORTGAGE LIFE INS CO	MN	0.0	2.0	2.0	376,582,372	408,438,470
CHRYSLER LIFE INS CO	MI	0.0	1.9	1.9	99,569,381	111,205,434
AMERICAN COMMUNITY MUT INS CO	MI	0.6	1.2	1.8	143,016,485	152,162,602
BL CROSS & BL SHIELD OF TX INC	TX	0.9	0.9	1.7	230,969,400	442,191,723
GUARANTEE TRUST LIFE INS CO	IL	0.0	1.7	1.7	142,971,704	150,712,797
STANDARD SECURITY LIFE INS CO OF NY	NY	0.8	0.9	1.7	117,350,930	124,690,065
PHYSICIANS MUTUAL INS CO	NE	0.2	1.4	1.6	493,020,417	504,623,311
FAMILY SERVICE LIFE INS CO	TX	0.3	1.2	1.5	554,035,746	582,784,071
LOYALTY LIFE INS CO	FL	1.0	0.5	1.5	435,435,149	447,216,737
FORD LIFE INS CO	MI	0.0	1.4	1.4	236,169,201	249,314,762
CAPITOL BANKERS LIFE INS CO	MN	0.0	1.4	1.4	363,066,040	375,130,577
HUDSON LIFE REASSURANCE CORP	FL	0.7	0.6	1.2	56,470,508	145,459,227
AMERICAN GENERAL GROUP INS CO OF CA	CA	0.0	1.1	1.1	204,942,977	216,209,163
MONTGOMERY WARD LIFE INS CO	IL	0.2	0.9	1.0	207,089,348	239,286,910
PHYSICIANS LIFE INS CO	NE	0.0	1.0	1.0	106,738,360	118,560,727

COMPANY	STATE	JUNK' BONDS/ INVESTED ASSETS	BBB' BONDS/ INVESTED ASSETS	JUNK+ BBB/ INVESTED ASSETS	INVESTED ASSETS	ADMITTED ASSETS
SECURITY BENEFIT LIFE INS CO	KS	4.4	3.4	7.8	1,741,434,393	2,397,812,668
BENEFIT TRUST LIFE INS CO	IL	2.0	5.8	7.8	313,076,051	367,649,348
ILLINOIS MUTUAL LIFE & CASUALTY CO	IL	1.6	6.2	7.8	314,393,874	332,364,868
UNITED FIDELITY LIFE INS CO	TX	3.0	4.7	7.7	332,170,134	368,236,486
CUMIS LIFE INS INC	WI	2.4	5.3	7.6	174,178,673	191,551,827
CENTRAL NATIONAL LIFE IN CO OF OMAH	NE	1.3	6.2	7.6	496,237,149	558,551,253
COLOGNE LIFE REINSURANCE CO	CT	3.2	4.4	7.5	227,554,849	307,101,700
SECURITY INDUSTRIAL INS CO	LA	1.7	5.8	7.5	141,901,660	146,927,094
GREAT SOUTHERN LIFE INS CO	TX	1.4	6.0	7.3	662,053,050	606,975,577
ITT LIFE INS CORP	WI	0.0	7.1	7.1	348,707,819	361,775,105
KANSAS FARM BUREAU LIFE INS CO INC	KS	2.0	5.1	7.1	225,929,697	237,039,615
INTER-AMERICAN INS CO OF IL	IL	6.4	0.6	7.1	102,354,662	130,567,006
NEW ENGLAND VARIABLE LIFE INS CO	DE	0.0	7.0	7.0	53,405,050	161,709,032
GOLDEN STATE MUTUAL LIFE INS CO	CA	1.2	5.7	6.9	108,895,534	117,723,030
COLLEGE LIFE INS CO OF AMERICA	IN	0.5	6.4	6.9	197,334,833	203,936,498
EDUCATORS MUTUAL LIFE INS CO	PA	1.2	5.7	6.9	119,791,168	126,715,843
UNITED INVESTORS LIFE INS CO	MO	4.9	1.9	6.8	494,450,860	598,504,003
EMPLOYERS HEALTH INS CO	WI	0.6	6.2	6.8	378,558,075	428,419,339
HOME BENEFICIAL LIFE INS CO	VA	2.9	3.7	6.6	1,050,922,333	1,081,138,776
STATE FARM LIFE & ACCIDENT ASR CO	IL	0.6	6.0	6.6	373,300,063	386,927,206
OHIO STATE LIFE INS CO	OH	1.9	4.7	6.6	532,570,960	544,214,404
FARMERS NEW WORLD LIFE INS CO	WA	1.3	5.2	6.5	1,618,419,322	2,130,160,404
AETNA LIFE INS & ANNUITY CO	CT	1.3	5.2	6.5	7,208,181,478	11,267,623,990
INVESTORS HERITAGE LIFE INS CO	KY	0.6	5.9	6.5	119,612,530	125,793,903
KANAWHA INS CO	SC	3.7	2.6	6.4	103,937,462	110,974,331
AMERICAN LIFE INS CO OF NEW YORK	NY	0.3	6.0	6.3	748,486,975	782,361,408
WESTERN STATES LIFE INS CO	ND	3.3	2.9	6.2	540,044,799	549,023,139
PHOENIX AMERICAN LIFE INS CO	DE	0.5	5.6	6.2	169,006,846	175,080,152
WESTERN UNITED LIFE ASR CO	WA	2.5	3.6	6.1	442,965,596	470,565,952
ARISTAR LIFE INS CO	UT	1.4	4.7	6.1	183,000,715	187,521,069
AMERICAN FIDELITY ASR CO	OK	0.5	5.6	6.1	568,970,605	639,160,653
FIRST STRATFORD LIFE INS CO	DE	6.0	0.0	6.0	380,590,175	411,474,210
STATE FARM LIFE INS CO	IL	1.2	4.7	5.9	11,746,696,150	12,132,208,408
CHARTERED PROTECTIVE LIFE INS CO	CA	2.4	3.5	5.8	100,865,550	107,763,013
EMPLOYERS REASSURANCE CORP	KS	1.6	4.2	5.8	1,002,130,319	1,214,163,565
FIDELITY MUTUAL LIFE INS CO	PA	0.0	5.6	5.7	1,141,670,709	1,236,560,206
WESTERN & SOUTHERN LIFE INS CO	OH	0.7	4.8	5.6	3,056,661,289	3,502,770,968
DESERET MUTUAL INS CO	UT	1.8	3.7	5.5	16,335,096	1,042,200,762
FORT DEARBORN LIFE INS CO	IL	0.0	5.4	5.5	110,445,042	123,322,613
AMERICAN CENTURION LIFE & ACC ASR C	CA	2.6	2.8	5.4	392,539,071	417,229,454
NORTH AMERICAN SECURITY LIFE INS CO	DE	0.9	4.4	5.4	209,735,659	1,090,137,979
PENNSYLVANIA NATIONAL LIFE INS CO	PA	0.2	5.1	5.3	114,079,051	117,907,119
MACCABEES LIFE & ANNUITY CO	MI	0.0	5.2	5.2	173,538,370	181,309,002
SIERRA GENERAL LIFE INS CO	NV	0.0	5.0	5.0	75,305,734	173,657,004
STANDARD LIFE INS CO	MS	0.7	4.4	5.0	144,565,926	146,963,360
STANDARD INS CO	OR	0.8	4.2	4.9	2,053,216,271	2,134,343,708
SOUTHERN LIFE & HEALTH INS CO	DE	4.8	0.1	4.9	184,181,493	193,047,106
ASSOCIATION LIFE INS CO INC	WI	2.6	2.2	4.8	157,168,642	163,509,298
WABASH LIFE INS CO	IN	1.0	3.6	4.7	323,479,099	334,379,151
UNITED AMERICAN INS CO	DE	3.0	1.5	4.5	618,065,686	639,560,623
MASSACHUSETTS IND & LIFE INS CO	MA	0.6	3.7	4.3	1,138,792,644	1,357,204,366
AMERICAN LIFE & ACC INS CO OF KY	KY	0.4	3.7	4.1	130,480,204	131,940,066
FIDELITY UNION LIFE INS CO	TX	0.8	3.2	4.0	784,317,163	806,043,506
CENTRAL STATES H & L CO OF OMAHA	NE	0.2	3.7	3.9	122,381,350	132,554,636
LYNDON INS CO	MI	0.2	3.7	3.9	770,664,190	1,072,479,118
INDEPENDENT LIFE & ACCIDENT INS CO	FL	1.7	2.0	3.7	993,004,714	1,031,247,247
WORLD INS CO	NE	0.2	3.4	3.5	109,046,680	113,703,019
HARTFORD LIFE & ACCIDENT INS CO	CT	0.3	3.1	3.4	1,648,532,956	1,856,274,290
JOHN ALDEN LIFE INS CO	NY	0.7	2.7	3.4	551,482,238	564,072,339
LIBERTY NATIONAL LIFE INS CO	AL	2.1	1.3	3.3	2,165,209,651	2,202,266,093
SETTLERS LIFE INS CO	VA	2.0	1.3	3.3	106,020,107	109,271,253
HARTFORD LIFE INS CO	CT	0.0	3.2	3.3	6,877,660,609	11,615,264,050
CELTIC LIFE INS CO	RI	0.0	3.2	3.2	119,502,240	136,870,759
UNITED GROUP INS CO	TX	0.4	2.7	3.1	107,363,632	113,066,612
COMMERCIAL BANKERS LIFE INS CO	CA	0.5	2.6	3.1	106,651,959	111,144,474
RELIABLE LIFE INS CO	MO	0.0	3.1	3.1	355,070,606	382,289,296
HEALTH CARE SERVICE CORP (MUTUAL)	IL	0.6	2.5	3.1	667,769,588	796,009,034
NORTH AMERICAN LIFE & CAS	MN	0.2	2.9	3.0	790,109,891	1,269,004,552
OXFORD LIFE INS CO	AZ	0.9	2.2	3.0	319,449,033	337,578,456
NATIONAL LIBERTY LIFE INS CO	PA	0.2	2.6	2.8	216,717,274	230,378,111
AUTO-OWNERS LIFE INS CO	MI	1.4	1.4	2.8	334,712,290	343,131,326
NORTH AMERICAN REASSURANCE CO	NY	1.0	1.7	2.7	494,930,915	644,323,711
GLOBE LIFE AND ACCIDENT INS CO	DE	2.4	0.2	2.6	613,847,039	654,003,620
CONSUMERS LIFE INS CO	DE	0.7	1.7	2.5	82,640,955	107,195,351
UNIVERSAL UNDERWRITERS LIFE INS CO	MO	0.2 .	2.2	2.4	135,516,739	142,629,574
BLUE CROSS/BLUE SHIELD OF FL	FL	0.0	2.3	2.3	358,599,779	625,246,762
MAINE FIDELITY LIFE INS CO	ME	0.2	2.1	2.3	442,295,042	455,260,329
BLUE CROSS & BLUE SHIELD OF KY INC	KY	0.0	2.3	2.3	247,660,059	347,009,455
GROUP LIFE & HEALTH INS CO	TX	1.2	1.0	2.2	102,295,403	137,620,634
AMOCO LIFE INS CO	NE	0.1	2.0	2.1	310,742,047	326,053,950
PEKIN LIFE INS CO	IL	0.4	1.6	2.0	197,501,210	203,691,085
STATE BOND & MORTGAGE LIFE INS CO	MN	0.0	2.0	2.0	376,502,372	400,430,470
CHRYSLER LIFE INS CO	MI	0.0	1.9	1.9	99,569,381	111,205,434
AMERICAN COMMUNITY MUT INS CO	MI	0.6	1.2	1.8	143,016,485	152,162,602
BL CROSS & BL SHIELD OF TX INC	TX	0.9	0.9	1.7	230,969,800	442,191,723
GUARANTEE TRUST LIFE INS CO	IL	0.0	1.7	1.7	142,971,704	150,712,797
STANDARD SECURITY LIFE INS CO OF NY	NY	0.8	0.9	1.7	117,350,930	124,690,065
PHYSICIANS MUTUAL INS CO	NE	0.2	1.4	1.6	493,020,417	504,623,311
FAMILY SERVICE LIFE INS CO	TX	0.3	1.2	1.5	554,035,746	582,784,071
LOYALTY LIFE INS CO	FL	1.0	0.5	1.5	435,435,149	447,216,737
FORD LIFE INS CO	MI	0.0	1.4	1.4	236,169,201	249,314,762
CAPITOL BANKERS LIFE INS CO	MN	0.0	1.4	1.4	363,066,040	375,130,577
HUDSON LIFE REASSURANCE CORP	FL	0.7	0.6	1.2	56,470,508	145,459,227
AMERICAN GENERAL GROUP INS CO OF CA	CA	0.0	1.1	1.1	204,942,977	216,209,163
MONTGOMERY WARD LIFE INS CO	IL	0.2	0.9	1.0	207,009,348	239,286,910
PHYSICIANS LIFE INS CO	NE	0.0	1.0	1.0	106,738,360	118,560,727

COMPANY	STATE	JUNK*/ BONDS/ INVESTED ASSETS	RRE*/ BONDS/ INVESTED ASSETS	JUNK+ RRE/ INVESTED ASSETS	INVESTED ASSETS	ADMITTED ASSETS
AMERICAN FAMILY LIFE ASR CO OF COLU	GA	0.0	1.0	1.0	6,328,391,359	6,535,392,531
DELTA LIFE AND ANNUITY CO	AR	0.1	0.8	0.9	555,562,641	568,226,059
CENTURION LIFE INS CO	MO	0.0	0.9	0.9	305,405,737	315,701,529
UNION NATIONAL LIFE INS CO	LA	0.2	0.7	0.8	192,894,679	199,705,912
LIBERTY LIFE ASSURANCE CO OF BOSTON	MA	0.1	0.6	0.7	981,041,237	1,243,962,204
RURAL SECURITY LIFE INS CO	WI	0.3	0.4	0.7	178,023,468	187,130,534
COLONIAL LIFE & ACCIDENT INS CO	SC	0.1	0.6	0.7	344,168,036	372,616,598
PIERCE NATIONAL LIFE INS CO	CA	0.0	0.6	0.7	161,562,775	170,573,122
AMERICAN GENERAL GROUP INS CO	TX	0.2	0.4	0.6	350,633,848	653,146,738
NATIONAL FARMERS UNION LIFE INS CO	FL	0.0	0.6	0.6	163,038,787	168,158,839
ARKANSAS BLUE CROSS AND BLUE SHIELD	AR	0.3	0.3	0.6	169,642,035	198,337,627
HERITAGE LIFE INS CO	AZ	0.0	0.6	0.6	92,152,344	102,597,954
TRAVELERS INS CO OF ILLINOIS	IL	0.0	0.6	0.6	113,325,282	143,829,368
LEGAL & GENERAL L I C OF AMER INC	DE	0.0	0.5	0.5	109,720,933	109,821,309
ZURICH AMERICAN LIFE INS CO	IL	0.0	0.4	0.4	124,818,000	128,817,420
PROVIDENT LIFE & ACC INS CO OF AM	TN	0.0	0.3	0.3	588,514,083	588,754,544
SAVINGS BANK LIFE INS CO	CT	0.1	0.2	0.3	182,001,982	185,689,696
INTEGRATED RESOURCES LIFE INS CO	IA	0.0	0.2	0.2	103,502,927	113,007,631
FAMILY GUARDIAN LIFE INS CO	AZ	0.0	0.2	0.2	213,309,848	238,571,210
ALABAMA REASSURANCE CO INC	AL	0.0	0.2	0.2	188,253,323	401,420,260
COMBINED INS CO OF AMERICA	IL	0.0	0.2	0.2	2,069,268,013	2,207,186,194
ASSOCIATES FINANCIAL LIFE INS CO	TN	0.1	0.1	0.1	646,853,681	659,900,547
TRANS WORLD ASSURANCE CO	CA	0.0	0.0	0.0	137,558,633	144,673,235
AGC LIFE INS CO	MO	0.0	0.0	0.0	1,099,741,201	1,102,527,001
LIFEUSA INS CO	CO	0.0	0.0	0.0	130,205,134	135,463,729
MONUMENTAL LIFE INS GRP INC	MD	0.0	0.0	0.0	228,551,701	234,851,043
BLUE CROSS & BLUE SHIELD OF NEBRASK	NE	0.0	0.0	0.0	136,812,987	149,344,269
TENNESSEE FARMERS LIFE INS CO	TN	0.0	0.0	0.0	194,977,878	202,711,085
HOUSTON NATIONAL LIFE INS CO	TX	0.0	0.0	0.0	151,874,635	152,211,273
AMERICAN FINANCIAL LIFE INS CO	TX	0.0	0.0	0.0	166,862,139	166,893,852
FIDELITY STANDARD LIFE INS CO	DE	0.0	0.0	0.0	191,055,112	199,549,677
FIDELITY INVESTMENTS LIFE INS CO	PA	0.0	0.0	0.0	31,349,207	171,307,824
RDI LIFE INS CO	TX	0.0	0.0	0.0	105,498,440	109,646,487
PRIMERICA LIFE INS CO	DE	0.0	0.0	0.0	724,022,028	726,506,709
FINANCIAL BENEFIT LIFE INS CO	FL	0.0	0.0	0.0	555,925,121	568,496,067
CONFEDERATION LIFE INS & ANNUITY CO	GA	0.0	0.0	0.0	107,082,969	115,300,419
FD ANNUITY CO	MI	0.0	0.0	0.0	270,687,116	275,368,340
FEDERAL HOME LIFE INS CO	IN	0.0	0.0	0.0	1,206,778,738	1,257,515,577
AMERICAN FIDELITY LIFE INS CO	FL	0.0	0.0	0.0	270,087,130	286,260,606
FORETHOUGHT LIFE INS CO	IN	0.0	0.0	0.0	354,909,074	365,870,720
WEST COAST LIFE INS CO	CA	0.0	0.0	0.0	617,274,462	643,515,030
MUNICH AMERICAN REASSURANCE CO	GA	0.0	0.0	0.0	117,620,663	127,373,194
CAPITOL AMERICAN LIFE INS CO	AZ	0.0	0.0	0.0	186,165,900	193,260,295
BROOKE LIFE INS CO	MI	0.0	0.0	0.0	478,997,032	480,670,408
TRANSAMERICA INS CORP OF CALIFORNIA	CA	0.0	0.0	0.0	1,224,790,457	1,241,220,206
MIC LIFE INS CORP	DE	0.0	0.0	0.0	188,930,666	209,170,064
SAVERS LIFE INS CO OF AMERICA	MO	0.0	0.0	0.0	225,635,400	230,028,243

APPENDIX C. DEFINITION OF TERMS

The following is a definition of some of the most important terms used in this paper and related publications.

Asset/Liability matching—The designation of particular investments to particular policy obligations so that investments mature at the appropriate times and with appropriate yields to meet policy obligations as they come due.

Average recession—A recession involving a decline in real GNP of 10 percent, which is approximately equivalent to the average of the postwar recessions of 1957-58, 1960, 1970, 1974-75, 1980 and 1981-82. It is assumed, however, that in the 1990's, the financial losses suffered from a recession of that magnitude would be greater than those experienced in previous decades. (See also "severe recession.")

Capital—In the case of stock companies, this refers strictly to the money raised through the sale of common and preferred equities. For mutual companies, this does not apply.

Capital resources—The sum of various resources which serve as a capital cushion to losses, including capital, surplus and Mandatory Security Valuation Reserve (MSVR).

Cash and demand deposts—Since this does not include government securities, it is normally a very small and insignificant item in most portfolios.

Common and preferred stocks—See "stocks" below.

Direct premiums written—Total income from insurance premiums.

Five-Year Profitability Index—See "Profitability Index."

Government securities—Securities which are issued directly by the Treasury (such as Treasury bills, notes and bonds) or those which have a full-faith-and-credit guaranty (such as Ginnie Maes). Excludes non-government guaranteed agency bonds or those which are considered merely a "moral obligation" of the U.S. Government.

Health claims reserve—Funds set aside from premiums for the eventual payment of health benefits.

Insurance risk—The risk that the level of claims will exceed reserves allocated for their payment.

Interest rate risk—The risk that due to changes in interest rates, investment income will not meet the needs of policy commitments. This risk can be reduced by efficient asset/liability matching.

Invested assets—The total size of the firm's investment portfolio.

Investment Safety Index—Measured on a scale of ten to zero, with ten being the best and seven or better considered strong. Each investment area is rated as to quality and vulnerability during an unfavorable economic environment.

Investments in affiliate—Includes bonds, preferred stocks, common stocks as well as other vehicles which many insurance companies use to invest in—and establish a corporate link with—affiliated companies.

Life and annuity claims reserve—Funds set aside from premiums for the eventual payment of life and annuity claims.

Mandatory Security Valuation Reserve (MSVR)—Reserve for investment losses mandated by the state insurance commissioners.

Mortgages in good standing—Mortgages which are current in their payments (excludes mortgage-backed securities).

Net premiums written—The total number of premiums written less the insurance which has been sold to other companies.

Non-investment grade bonds—Low-rated issues, commonly known as "junk bonds," which carry a high risk of default (as defined by the state insurance commissioners).

Nonperforming mortgages—Mortgages which are (a) 90 days past due or (b) in process of foreclosure.

Other investment grade bonds—All investment grade bonds other than those included under "government securities," including: (1) Nonguaranteed obligations of the U.S. Government, (2) rated state and municipal bonds, plus (3) investment grade corporate bonds (as defined by the state insurance commissioners).

Other investments—Items not included in any of the other categories such as premium notes, collateral loans, short-term investments and other miscellaneous items.

Policy leverage—The value of policies written in proportion to capital resources.

Policy Leverage Index—A composite index of policy leverage in each line of business.

Policy loans—Loans to policyholders under insurance contracts.

Profitability Index—A composite of five factors: (1) gain or loss on operations, (2) consistency of operating results, (3) impact of operating results on surplus, (4) adequacy of investment income as compared to the needs of policy reserves, and (5) expenses as a percent of revenues.

Real estate—Direct real estate investments including (a) the property occupied by the company and (b) properties acquired through foreclosure.

Reinsurance assumed—Insurance policies acquired in part or in full from other companies. (See "reinsurance ceded.")

Reinsurance ceded—Insurance policies sold to another company.

Risk-adjusted capital—The capital resources which would be needed in a worsening economic environment. (Same as "target capital.")

Risk-Adjusted Capital Ratio #1—The capital resources which a company currently has as a ratio to the resources which would be needed in an average recession.

Risk-Adjusted Capital Ratio #2—The capital resources which a company currently has as a ratio to the resources which would be needed during a severe recession.

Safety Rating—The Weiss Research rating encompassing five major factors and ranging on a scale from A (highly recommended) to F (failed).

Separate accounts—Funds segregated from the general account that contain deposit funds for variable annuities and universal life policies.

Severe recession—A decline in real GNP of 20 percent or more. During the Great Depression, real GNP declined by 46 percent, from $103.1 billion in 1929 to $55.6 billion in 1933. (See also "average recession" above.)

State of domicile—Although most insurance companies are registered to do business in many states, they have only one state of domicile. Use the state of domicile to make absolutely sure that you have the correct company. Bear in mind, however, that this need not be the same state as their main offices.

State guaranty funds—Most—but not all—states currently have state guaranty funds which are designed to raise funds from existing insurance carriers to cover policy claims of bankrupt insurance companies.

Stocks—Common and preferred equities, including stocks in affiliates.

Surplus—The statutory equivalent of "retained earnings" in non-insurance business corporations.

Target capital—See "risk-adjusted capital."

Total assets—As the total of all investments and business interests, this is the most common measure of size used in the industry.

Senator BRYAN. Thank you very much for your testimony. Mr. McCartney gets the first question. What is wrong with Mr. Weiss's proposals?

Mr. MCCARTNEY. To be perfectly frank, Mr. Chairman, this is the first that I had heard of them, and I would just as soon not make any comment until I have had time to not only think about it myself but to talk about it with people who know a lot more about this than I do.

Senator BRYAN. We will keep the hearing record open to give you the opportunity to do so.

Mr. McCartney, as I understand, the NAIC established a junk bond working group some time last year. Am I correct on that?

Mr. MCCARTNEY. Yes, sir.

Senator BRYAN. And you had several meetings, or a couple of meetings? Tell me a little bit about how that working group operated.

Mr. MCCARTNEY. Yes, Mr. Chairman, it was established in late January, early February, of 1990. I cannot remember specifically how many States were on it, but seven, eight, or nine, something like that. It was chaired by Illinois.

Senator BRYAN. As you know, there are certainly critics of State regulation and critics of State action as well as the NAIC. My understanding, from information which has been provided to this committee, that the noninvestment grade bond working group, as it has been called, concluded in late December of last year, 1990, that the companies—referring to these companies that had large junk bondholdings, and specifically Executive Life companies—are capable of meeting their current and projected cash-flow requirements, that a number of hypothetical future economic environments requested by the working group was considered, and the studies illustrated the companies' ability to meet their obligations under adverse circumstances.

In summary, the working group's conclusion that the companies are capable of meeting all current and projected obligations was founded on the review of available data. Now, that is less than 4 months before the insurance commissioner of California, as you know, petitioned for the conservatorship, followed by 5 days.

Mr. McCartney, I have to say that does not inspire great confidence in the evaluation of the NAIC in terms of the condition of those companies. Let me give you an opportunity to respond.

Mr. MCCARTNEY. To respond, I need to give you a longer answer than you might care to hear, but I need to give you some history of what the NAIC was doing in 1990.

Once we put together that working group we had a couple of meetings right away in February, then in early March, then we developed a plan in conjunction with California and New York, but specifically in conjunction with California, and outlined a number of steps that the working group wanted to see California take and ordered the company to take. Included in that was the retention of Milliman & Robertson, a well-respected actuarial firm.

The actuarial firm did a number of analyses on the company's surrenders and an analysis of its investments and its book of business. Initially, one of the great impetuses for the creation of this working group was the dramatic increase in surrenders that Executive Life was experiencing in the early part of 1990.

In the history of the company, the average surrenders for the company prior to 1990 were $100 million per month. So that sounds like an incredible number, but you need to know that that is sort of the average number up until the beginning of 1990.

Then, commencing around January 1990, all of a sudden those tripled and in some cases quadrupled to where surrenders were $300, $400 million a month, and we became very concerned. We became concerned what will happen if surrenders continue at this rate?

In January 1990, the company had something like $1.2 billion in liquid assets—cash and cash equivalents, assets that could be readily converted to cash—to handle these pay-outs of surrenders. But at $400 million a month, that was not going to last too long, so we had Milliman & Robertson do a number of studies.

As the year went along the surrenders tapered, and in the last half of the year they were back down to their historical levels—about $100, maybe $150 million a month—but toward November and December they were $100 million a month. At that time, M&R had done some actuarial studies. We had received the results of those. Even in the worst case scenario, the company appeared to be able to continue to meet its obligations.

Having endured all of that, the company still in December 1990 had about $1 billion in cash and cash equivalents. It still was in a fairly—well, more than fairly—it was still in a pretty liquid condition with respect to surrenders. So, as of December, based on the information we had from M&R, based on the company's liquidity at that point, it did not appear that the company was in any imminent financial danger.

In 1991, the junk bond market continued to deteriorate, but probably the most important blow was the filing of the forms with the Securities & Exchange Commission and the filing of the certified public accountants that indicated the CPA firm had reservations about the First Executive as an on- going concern.

Once that happened, the proverbial run on the bank began, and the States of California and New York, and even Nebraska, where we have three subsidiaries of First Executive Corp., the States where they were domestic subsidiaries, had no choice at that point but to take some kind of regulatory action against the company.

But in December 1990, when that statement was issued, the situation was different from the situation in March or April of 1991.

Senator BRYAN. Mr. McCartney, it may be fair to say that it was not as critical as it turned out after the filing with the Securities & Exchange Commission, but your fellow Commissioner, Mr. Curiale, indicated that way back in the 1980's, 1985, 1986, they had some very serious concerns about Executive Life. You were here, and you heard him describe their efforts to require, prospectively at least, a reduction in terms of the acquisition of new junk bonds by—I believe they had a 20-percent rule.

I must say that in the testimony we have had today, and in gathering the record, we have major rating companies that are rating these Executive Life Companies AAA or A-plus—the top ratings. You mentioned the name of Milliman & Robertson. I confess to you, I do not know who they are, but you certainly get the sense—if you are an outsider looking at this industry, you sure get the sense that nobody knows what the hell they are talking about.

I mean, all of these people are saying, look, there is no worry—this is fine—and the consumer, the buyer of insurance, is not aware of these problems. In fact, we had a piece of correspondence from one of our constituents in Nevada, I suspect not atypical of what many Senators are now getting, indicating that throughout last year he had checked with various insurance brokers, had written to the insurance Commissioner's office—let me be fair, not in your State, Mr. McCartney—and was assured that they were, to use his language, "a pillar in the insurance business."

Now, I do not think by any fair standard, looking back at what has occurred, that that was a fair or accurate characterization. Moreover, at the same time in December, apparently the State of New Jersey and its insurance department moved to demand a $500 million deposit from the Executive Life companies, and NAIC passed a resolution which is highly critical of the action taken by New Jersey.

It goes on to say, and I quote from the resolution, "that the NAIC believes that the action taken by the State of New Jersey is unsupported by sound technical and actuarial expertise, finds the unilateral action taken by New Jersey's Insurance Department as unacceptable." It strikes me that at that point in time, NAIC, rather than being aggressive, rather than being lions and defenders of the consumer, is trying to urge restraint and caution. Now, that is what it appears.

Again, let me get your response to that, because you have postured yourself as an aggressive organization that is imposing some new standards and regulations prospectively, and you are telling us what the States are doing, yet here it seems like you are kind of trying to keep everybody in check—do not move too aggressively—whereas it seems to me the record would suggest that maybe everybody ought to be moving more aggressively in terms of this company in its history, as we proceed through the 1980's.

Let me defer to you for your response.

Mr. McCARTNEY. Mr. Chairman, as you indicated, our prime goal was the protection of the consumers, and it has been with Executive Life and with other insurance companies.

In December—discussions about some kind of special deposit in New Jersey had been going on for several weeks prior to the December NAIC meeting.

Had that occurred, it would have been very, very harmful to consumers for a couple of reasons. First of all, you have to look at what if every State had demanded $500 million deposits from Executive Life? The company was not in a position to do that.

In addition, New Jersey, my recollection is, had total business in force, business at risk, of something like $150 million. The $500 million request was just not in line.

Second, at that point we were still getting actuarial reports and other indications, and we had requested additional information from the company, on exactly what the status of the financial situation was. It was evolving.

The situation in January 1990 was different from June 1990, which was different from March 1991, but as that evolved, one of the things that we were most concerned about was a run on the bank. Initially, early on in 1990, there appeared to be a run on the bank occurring. That had moderated. It had gotten under control, where by the end of 1990 the run on the bank had ceased. Had New Jersey been effective in demanding and securing that $500 million special deposit, we were very concerned it would create, or begin, the run on the bank all over again.

Senator BRYAN. But Mr. McCartney, that might very well have saved those who invested or purchased policies subsequent to December 1990, or sometime in the mid-1990's, and although I know the industry resists these parallels, and I want to be very careful not to indicate that I think in all respects they are applicable, if one looks at the history of the savings and loan regulation, it was the failure and the reluctance of regulators to move aggressively that compounded the enormous risk and consequent cost to the taxpayer.

If one looks at the regulation in the banking industry as recently as the Bank of New England's failure, it was the failure to take earlier action that exposed the fund and ultimately potentially the taxpayer to greater risk. Cannot one who is objective and fair conclude here that the failure to take action earlier in fact increased the liabilities and the risk, ultimately, to policyholders in the case of Executive Life?

Mr. MCCARTNEY. That is not entirely accurate, Mr. Chairman. The reason for that is that we, as part of our biweekly and monthly reports, were getting information on the company's issuance of new business and, for the most part, beginning in 1990 the spigot of new writings continued to turn in an off direction. By the end of the year, there was virtually no new business being written by Executive Life. The reason for that was basically adverse publicity.

From my perspective, I do not think it would have mattered if California had taken steps in December 1990, or September 1990, or June 1990. We would be in about the same position we are today. There were not that many new policies issued. There was not a significant number of new policies and new premiums written in the last half of 1990.

Senator BRYAN. You may very well be correct. I suppose "significant" would be in the eye of the beholder. If you were the one who purchased a new policy in the time period thereafter, it would not appear to be insignificant to you, although I understand the point that you are making.

Let me ask you something a little bit broader, if I may, because of the responsibilities and office that you hold with the association. Describe to us, if you will, so that we can have it in the record, how the guarantee fund associations work, and I realize there may be some variations in coverage in the various States, but there are 47 States, as I am led to believe, that have these guarantee funds, and they generally operate on similar principles.

Would you describe how that works, and if indeed an insolvent determination is made, how that will work in terms of what options or what rights, I guess, the policyholders of Executive Life may have, and how they can rely upon those guarantee associations to at least hold them harmless, in part, from some of the risks that they have?

Mr. McCartney. Yes, Mr. Chairman. There are 47 States. Each one is a little bit different, but for the most part they are fairly uniform. Some will have differences in the maximum amounts of coverage.

Most of the States require a determination of insolvency of the insurance company before they kick in. There are a few States that, in addition to that trigger, also have a trigger if the company ceases paying claims, but for the most part it takes a finding of insolvency.

Once the finding of insolvency is made, then the guarantee funds are triggered and begin basically standing in the shoes of the insurance company, begin paying the claims, doing the things that the insurance company will do, until then at the end of the day when the insurance company has been liquidated and there is a clear definition of what the assets are, then the guarantee funds get repaid according to statute, out of the moneys left at the end of the day.

In Nebraska, we cover annuities up to a total cash value of $100,000, and face value of life insurance up to a total of $300,000, and cash value in life insurance policies up to $100,000. That is a fairly typical amount of coverage.

Senator Bryan. Mr. McCartney, is it fair to conclude that generally speaking there is a finite limitation on the amount of coverage that the guarantee funds have? That is to say that there is no indefinite open-ended—so that someone who, for example, had a policy of $1 million, would not, under most States, be covered in the full amount of the face value of the policy, based upon the approach that you have indicated is a pattern in Nebraska, where there are some finite limitation—$100,000, $300,000?

Mr. McCartney. That is true, Mr. Chairman.

Senator Bryan. How about the GIC's, the so-called guaranteed investment contracts? Are those covered by the guarantee funds in most States?

Mr. McCartney. There is a dispute about that. In most States, the guarantee fund laws read that unallocated annuities are not covered, and some States have held that guaranteed investment contracts or unallocated annuities are not covered. In other States there has been a differing interpretation. So, this is an area that you really have to go through on a State-by-State basis.

For the most part, I think guarantee funds, unless there has been a decision otherwise, would maintain that they are not covered.

Senator Bryan. We heard in earlier testimony that NAIC revised its classification of junk bonds, that previously some bonds that were not investment grade were not classified as junk bonds, as I understood it, and that thereafter NAIC had adopted a rule that made the junk bond definition far more extensive, and for that reason the percentage of junk bondholdings in these insurance companies has risen dramatically.

My question is, Why did NAIC originally have a different—a lower standard, if you would, in terms of what it considered junk bonds?

Mr. McCARTNEY. I am not sure it was a lower standard, Mr. Chairman. We had a system whereby there were several categories, with the first two being yes, meaning they are investment grade, and then the bottom four, or the bottom two, or whatever the number is—Terry Lennon is the architect of this, and he would really be the person to ask.

But the bottom group then would be—well, the first category is yes, and then all of the remainder would be no, and there was really a concern by the technicians in the State Insurance Departments that we needed to have broader categories, that this really did not reflect the difference in categorization maintained, for example, by the other rating agencies.

So, we then went from the previous four to six, and with the first two categories, 1 and 2 being investment grade, 4, 5, and 6, being below investment grade, and then that middle category, 3, either being as Mr. Weiss said, near junk or near investment grade.

Mr. WEISS. I have the chart here. No. 3 is the BB. That is the highest category of junk bonds. No. 2 would be the BBB.

Mr. McCARTNEY. OK, and the effect of that, Mr. Chairman, as Mr. Weiss indicated earlier, is then, beginning this year, when that kicked into effect on last year's financial statements, a number of companies' financial statements did reflect—as they allocated their portfolios to those new categories, did reflect an increase in bonds that were in the junk bond type categories, the noninvestment grade groups of categories.

Senator BRYAN. Mr. McCartney, I guess your critics would say that you are constantly playing catchup, that maybe the horse had already gotten out of the barn by this time. What was it that prompted you to do the reevaluation of what constitutes a junk bond at the time that you did, as opposed to having done it in the mid-1980's when the junk bonds began to hit the market, and particularly the insurance industry, in a major way?

Mr. McCARTNEY. In many respects it was a reflection of the allocations of junk bonds, or allocations of bond portfolios, done by the rating agencies—to bring the NAIC's evaluations more in line with those of the rating agencies.

Senator BRYAN. Mr. Weiss, tell us a little bit about your proposal for disclosure, and tell us a little bit more what you had in mind? It sounded like you had in mind some type of, if not an unqualified, at least a limited immunity for rating companies that provide the kind of information which investors and consumers generally ought to be able to rely upon.

Mr. WEISS. First of all, let me address the issue of full disclosure.

Senator BRYAN. Please.

Mr. WEISS. The NAIC should be applauded for disclosing the data which has permitted us and other rating agencies to bring this to the attention of the public, but the real issue of disclosure is at point of sale. In other words, the agent and the sales person. That enforcement and format should be very clear.

It is not a simple issue, because there are many areas of weakness in the insurance industry that we have not even discussed yet today, and therefore disclosure should cover all of those areas.

Senator BRYAN. What type of disclosure do you have in mind?

Mr. WEISS. Well, in the investment industry, if you buy an investment product you are presented with a prospectus which has in bold letters many different disclaimers. Specifically, for example, a disclaimer saying that the SEC or the Government does not guarantee this investment, and no statement should be interpreted that way.

Today, we have talked about "guaranteed investment contracts." As far as the consumer is concerned, it sounds like it is being guaranteed by some Government body when it really is not, and as it turns out,it is not even covered by most of the States.

The first thing that has to be disclosed is that there is a risk, and it should be done in terms that are easy to understand for the consumer. That disclosure should include a number of different parameters, a number of different ratios, reflecting various potential areas of weakness.

However, I would like to add that there are many companies, because of their particular, individual circumstances, which might not fit into an overly simplified format. So, you have the problem of covering all the potential weaknesses, making it easy for the individual to understand, and still having built-in flexibilities so that companies with special circumstances do not look bad, just because the format was ill-designed.

As to the issue of legal——

Senator BRYAN. You are suggesting Federal law to require that.

Mr. WEISS. That is correct.

Senator BRYAN. Would that be available to the purchaser of insurance at the point of sale, is that the idea?

Mr. WEISS. That is correct. I feel that this should be done on a national level because if it is done on a State level, I think that some of them have done a good job in regulating—but we have a problem of variability from State to State. Each State is different, and if one State imposes one form of disclosure and another State imposes another form of disclosure, it will be unfair to the companies.

Some companies will be forced to disclose more and some will be forced to disclose less, and the PR departments will get hold of that and turn it around, twist it around, if they have that ability. So, this has to be standardized on a national level and that is where I feel the Federal role would come in.

Senator BRYAN. Would you explain a bit more about the immunity concept you have for the rating agencies?

Mr. WEISS. There is no immunity under the first amendment, of course, from lawsuits. No one is immune; everyone can be sued. But there is a difference between public speech, which the news media is producing, and private speech. It is not clear under the law where the rating agencies fall, and indeed, the history indicates that they are far more vulnerable to the threat of lawsuits than the news media is.

In the case of the news media, for example, in most instances malice has to be demonstrated in order to prevail. In the case of a nonnews situation, then it is merely a matter of negligence. Now, if you are rating 1,000 companies or 1,700 companies, it is not unusual for there to be an error, either in the original data base, such as the NAIC's, or in the Best data base, and so forth.

Add to that factor the very substantial legal budgets of hundreds of large insurance companies and the potential for intimidation against the rating agencies and you will see why, or at least one of the reasons why, the rating agencies were hesitant to warn the public about the problems at Executive Life and are today still hesitant to warn the public about other companies which we have cited today and which I have in my tables.

Senator BRYAN. NAIC, as you know, is proposing a national standard, and Mr. McCartney shares with us that a number of States have adopted this to date and anticipates a number of others, as well. Some who have less confidence in the willingness of all States to do so have suggested that maybe we ought to have a national standard, in terms of minimal standard. What would be your response to that?

Mr. WEISS. There is a place, I believe, for minimal standards in the insurance industry.

Senator BRYAN. I am talking about a financial standard.

Mr. WEISS. For example, "You cannot have a ratio below X, Y, Z. You cannot have more than this much in junk bonds." I think there is a place for that. As we have seen, it is difficult to enforce, and number two, on the flip side of everything we have said today, we must recognize that risk is not necessarily a four-letter word, although it does have four letters.

In other words, there should be someplace in our country for risk, for new innovative financial instruments, provided that the consumer is told about it ahead of time. Now, in the case of insurance, naturally most consumers buy insurance for protection and not for risk, and therefore if there is a place for risk in this industry, it will tend to be—if we let the market forces play themselves out—it will tend to be a niche.

But it should be there, nonetheless, because I can think of some cases in which an investor with substantial self-insurance abilities would want to take some risk in exchange for higher benefits. Maybe he is very "bullish on America," and therefore he feels that the risk is really not a practical one today.

Therefore, going back to your earlier question, if we try to impose too many limitations, too many different parameters that you absolutely must fit into, then we will be destroying the aspect of diversity and different types of products available to the consumer.

If he is told up front, "Here are your benefits, here are your costs on a standard, comparative basis, and Mr. Consumer, here are your risks and the potential risks based on these wide range of parameters," then he can make that decision whether he wants the safety or the risk.

Senator BRYAN. Senator Metzenbaum mentioned surplus notes, and characterized those in a fairly pejorative fashion, do you know anything about that, Mr. Weiss? And if so, could you share it with us?

Mr. WEISS. They sound very much like the net worth certificates that were issued in the savings and loan industry, which today are jokingly described as the "not worth certificates." I believe they arise from a dilemma that the insurance regulators find themselves in today, and that has been expressed earlier.

The question is, How do you prevent the so-called run on the bank situation? Is it by "protecting the consumer from the information we do not want him to know," by creating an aura of darkness and uncertainty? Or is it by letting the facts out up front so that, with rational, objective, balanced information, the consumer then can make the right decisions for all of us.

That is good for the consumer, because he will get what he really wanted; it is good for the insurance industry, because the weak companies, the rotten apples, will not hurt the good companies. They will be kept in separate categories. And, finally, it is good for the regulators because it helps relieve their burden of policing on a micro level all of these hundreds of different new policies and different financial instruments.

Senator BRYAN. Mr. McCartney, let me ask you—if you want to respond to that, do so, and then I have a couple more questions. Go right ahead.

Mr. MCCARTNEY. If I may, Mr. Chairman.

Senator BRYAN. Sure.

Mr. MCCARTNEY. With all due respect to Senator Metzenbaum, I am not sure he has the concept of surplus notes down exactly the way they work, and I would like to take an opportunity maybe to address that.

Senator BRYAN. Please.

Mr. MCCARTNEY. Surplus notes are a great way for an insurance company to raise capital. For a mutual company, for example, that does not have stock it is one of the very few ways for it to raise additional capital to support additional writings. It also works for a company like Executive Life or other companies that are owned by a holding company where the holding company wants to put additional funds into the insurance operation without purchasing stock.

And the way they do it, for example, Senator Metzenbaum talked about a particular surplus note—and I cannot remember the number, but I think it was about $175 million, something in that neighborhood. First Executive Corp. put cash into the company, whatever that number was, $120 million, put $120 million of cash in the company.

In return, Executive Life Insurance Co. issued a surplus note, said that you have a call on our surplus for the amount of the cash you put in.

Senator BRYAN. Now, let me stop you there, Mr. McCartney, because as I understood the comment that Senator Metzenbaum made, he was highly critical that these notes are not reflected as liabilities of the company. Could you address that? Is he correct in your understanding?

Mr. MCCARTNEY. That is correct, Mr. Chairman. They are not contained in the liabilities section of the balance sheet. They are contained in the capital section of the balance sheet. And the reason for that is, they are much like a stock certificate.

The reason they are much like a stock certificate is because that is where they stand in line if the company is liquidated. Surplus notes do not get repaid anymore than a stockholder gets repaid if the company is liquidated. They are at the end of the line when it comes to calling on the assets at the end of the day.

Senator BRYAN. Let me make this point, though, and help me to understand this. A stockholder is one who participates in the equity. Typically, a noteholder is one who is a creditor. Tell me in which category those who hold surplus notes find themselves, because obviously creditors take a priority position to stockholders.

Mr. MCCARTNEY. They find themselves in the category of a stockholder. It is unfortunate that over the years these have become surplus notes because that does not accurately reflect the way they are treated. They cannot be repaid without the prior consent of the director or the commissioner or the superintendent of the State of domicile of the insurance company.

Senator BRYAN. So, in terms of where one stands in line, you are indicating, if I understand you correctly, that a holder of these surplus notes would always follow in terms of payment any of the general creditors of the company.

Mr. MCCARTNEY. Absolutely, and that is why they are not carried up with the other liabilities. They are carried down in the capital and surplus section.

Senator BRYAN. OK. Mr. McCartney, just a couple of other questions here before we concluded. We were talking about the guarantee fund associations and you were explaining its general operation.

It is my understanding that in many States that the concept of the guarantee fund association involves an assessment against other healthy carriers, in this instance, other healthy life insurance companies, that that assessment in many States permits them to offset their insurance premium tax to the State or in some States gives them an automatic pass-through to increase the premium to policyholders.

In either case, if I am correctly informed, ultimately the public in the form of the policyholders or the taxpayers pick up the ultimate tab. I know in our own State of Nevada, the insurance premium tax is the third largest source of revenue that State government relies upon.

Tell me if my understanding is correct and, if not, if you will clarify my understanding.

Mr. MCCARTNEY. Mr. Chairman, your understanding is exactly correct.

Senator BRYAN. What is your situation in Nebraska, Mr. McCartney? How do you treat it there?

Mr. MCCARTNEY. We allow companies to have a premium tax offset in the amount of their assessments from the guarantee funds, but at the same time, it is subject to certain limitations so that the whole premium tax does not get eaten up in any 1 year.

Now the NAIC has been looking at this, and we have appointed a blue ribbon panel that is cochaired by Jim Long, who is president of the NAIC, and by John Dillon from Indiana, that is looking at this whole issue of guarantee funds.

You know, they have been around for a long time. They have been around 20 years or more, and we believe that they have worked well. No insurance consumer has lost so far a penny. But we want to make sure that they are going to continue to work in the future, and that when we have these cases where you have to liquidate a company doing business on an interstate basis, that we get the kind of coordination that we need.

It may be that this working group will find that guarantee funds are working well and can continue to work in the future and it may be that that working group will come up with some very dramatic recommendations for changes in the guarantee funds structure. I do not know, but we will have some kind of resolution by the end of this year.

Senator BRYAN. Mr. McCartney, as we talked during your last visit before the committee, the makeup and the structure of those guarantee funds, I think, is extraordinarily important, more so than the last time that we talked, in the light of what may be an imminent insolvency on the part of a company that has 300,000 policyholders and $48 billion to $50 billion of coverage.

As you know, in some States the guarantee funds are beyond the pale of State sunshine laws. That is, they are not subject to open meeting requirements, notices. In some States, the guarantee funds are comprised essentially, if not entirely, of only members of the industry themselves.

I think, in light of their increasingly important role, as we face these problems, that you need to take a look in terms of what protection there is to the general public who is in a position in the case of an insolvency of relying upon the way that fund is operated and the decisions made by those members of the Guarantee Fund Association, which is not strictly, you know, a private decision. It has tremendous import, potentially in this case, 300,000 people may be affected by its decision.

I would hope that maybe you are taking a look at some guidelines that you are going to recommend as to the way that those associations ought to be operated in terms of their appointment and subject to, you know, open meeting requirements, which under some States they are not.

Mr. MCCARTNEY. We heard your concerns at the last hearing, Mr. Chairman, and as a result of that corporate governance or governance of the guarantee funds is an issue that that committee is looking at.

Senator BRYAN. One last question, then. I have held this off so that Senator Exon, who bats cleanup on this committee, can get the final word.

Mr. McCartney, one of the things as I talk with some of your colleagues across the country that strikes me as being a problem, in the case of Executive Life of California, domiciled in California, a State with 30 million people—your State of Nebraska probably has got, what, 1.8 million, something like that, as your population—if memory serves me correctly.

Mr. MCCARTNEY. 1.4 million.

Senator BRYAN. 1.4 million?

Mr. MCCARTNEY. 1.5 million.

Senator BRYAN. 1.5 million. We have got 1.3 million, and so I sense that in effect that those States that were more aggressive than the predecessor administration in California would talk to Executive Life and urge them to do various things, and to some extent there was a sense of frustration.

But, my frustration is that I did not see the kind of aggressive action that I thought ought to be taken by individual insurance commissioners in the nondomiciliary States, that when they were genuinely concerned about the solvency and the safety of Executive Life seemingly felt constrained not to take any action, that is, to suspend the future sale of policies or to move aggressively to petition in their own State court systems for conservatorships or other types of remedial action.

Is that inherently a structural flaw with the diversity of 50 State regulators? Because it strikes me each of you have a particular responsibility, in your instance, to your Nebraska constituents, in my own State, to the Nevadans who were involved and purchased something in the neighborhood of 2,500 policies of one sort or another from Executive Life.

If the standard of action becomes the least common denominator of the action that the domiciliary commissioner takes, then in effect, if that State's commissioner is not aggressive for whatever reason, and everybody else just kinds of stands in line—and I must say, in fairness, that the action which was taken last December by the NAIC, when it chastised the commissioner of New Jersey—tends to give one that impression, that here we keep everybody in check so that nobody gets out in front of the ball game. Let me ask your response to that.

Mr. McCARTNEY. I think there could be a perception that the 51 different jurisdictions, or the 55 if you count the territories, that that is a structural flaw in the system, and in certain respects, I guess it could be.

But I choose to believe, and I have seen it work the other way, there have been occasions where the State of domicile may not have taken the kind of actions that other States believed were necessary. And that the other States, working in conjunction, can force that State of domicile to take actions that the other States believed are necessary.

There are situations where the State of domicile department of insurance may not be as strong as others would like and the stronger States work as a check and balance. I do not think that the system that we have brings everybody down to the least common denominator.

I think, on the other hand, it tends to raise everybody up, that all of us try to be like New York and the other strong States, and we know if we fail at that, New York is going to be pretty tough on our domestic companies, and I choose to believe that it works the other way.

Senator BRYAN. Mr. McCartney, I would be the first to acknowledge that in Nebraska you cannot influence or control the decision of the California insurance commissioner, other than by importuning him or her to take a particular course of action. You have no ability to cause a change in policy other than as that commissioner chooses to do so.

What I would like to hear, and I would ask you this, if this is true, if you are satisfied as a commissioner in Nebraska that indeed whether it is Executive Life or any other insurance company not domiciled in your State, that you believe that there is a risk to the policyholders of your own State, do you have the power under Nebraska law to say, notwithstanding the actions taken or inaction taken by the domiciliary commissioner, that you can in effect suspend the sales of insurance and indeed petition in your own State court system for a conservatorship or other type of judicial administration to protect your policyholders, as you believe that their best interests require?

Mr. McCARTNEY. Yes, Mr. Chairman, we do have that power. In addition, working together collectively through the NAIC, when we believe we have seen an instance where the State of domicile has not taken the kinds of steps that we want it to take, we work collectively and require certain information from the State of domicile. And if we do not get it, we tell the other States that, hey, we have got some serious concerns about this company. We do not think the State of domicile is doing the things it needs to be done. You probably ought to take the steps that are available to you in your State to deal with this potential problem with this company.

Senator BRYAN. I know you probably do not have this information right at the tip of your tongue, but would you provide me with a list of those situations in which a nondomiciliary insurance commissioner took affirmative regulatory action, either in the form of a petition for conservatorship, an order suspending the operation of the company in terms of the issuance of new policies, when the domiciliary insurance commissioner, for whatever reason, had failed to take that action?

In other words, where the individual insurance commissioner took more aggressive action than did the domiciliary commissioner. And you may be able to provide that information for me.

Mr. McCARTNEY. We will get that to you.

[At the time of printing the information referred to was not available.]

Senator BRYAN. Great. I will appreciate that.

Let me now yield to Senator Exon.

Senator EXON. Mr. Chairman, thank you very much.

Senator EXON. Mr. Chairman, thank you very much.

Gentlemen, it has been a long morning and I am going to try to be as brief as possible, but there are a few things that I would like to cover.

First, following up on the line of questioning that the chairman has just been pursuing, is there not a down side, or another concern that we have with the lack of cooperation, coordination and understanding among the various Insurance Commissioners with regard to some States that I have heard about?

I will not mention their names here, but I think there are a few States at least that seem to take particular joy in writing rules and regulations with regard to acceptance or nonacceptance of that particular policy from a particular company being sold in their State, use picayunish rules, regulations and red tape that have little to do with solvency of the company. Rather, they seem to take the bureaucratic approach that that policy cannot be sold in this particular State, regardless of where the company is domiciled, because of this or that picayunish decision with regard to what should be stated in the policy and in what form. Is that not a problem in Nebraska, to some extent, Mr. McCartney, and probably in other States?

Mr. McCARTNEY. Well, I have not heard that it is a great problem in Nebraska. I have heard anecdotal evidence that companies have had similar problems in other States.

One of the great things about this 51-jurisdiction system of regulation, however, is that if one State becomes completely intolerable a company is free to move its resources and its capital to another State where there is a more favorable business community.

If we had one, huge, national—or I will use the word Federal standard, and the Federal regulator had overwhelmingly picayunish requirements, the insurance industry would not have that freedom to move its capital around.

Senator EXON. At your national meetings, do things of this nature come up for discussion if a particular State seems to be picayunish with regard to it trying to dictate what the wording should be in a particular policy? Do things like that come up for discussion and get the input of the various Commissioners?

Mr. McCARTNEY. For the most part, Senator Exon, we have spent a huge portion of our efforts on solvency and a huge portion of our efforts on marketing practices of insurance companies. From my perspective, I think once we get a handle on some of those things, what we need to do is look at the service aspects of insurance departments, exactly what you are talking about.

How long does it take to get a policy form approved? Is there any reason for a good, solid, well-rated company from a good State of domicile to have to wait 2 years to get approval to do business in another State? Those are things that I hope we look at.

Senator EXON. You are keying in on what was essentially my question. I am glad you are aware of it. I think something should be done about it. Certainly solvency is the big concern right now. I understand that.

In that regard, Mr. Weiss, I understood--and I apologize for having to break away. I had some other commitments that I had to keep, including being there in the Budget Committee to form a quorum, but this is a tremendously important meeting, Mr. Chairman, and I want to thank you again for calling this, because we just have to get into these things.

I understood, Mr. Weiss—and if I could paraphrase, I guess what you said, you feel that there are serious problems ahead in the insurance industry as a whole, and therefore you seem to feel that some type of Federal involvement is a necessity, is that a fair summation?

Mr. WEISS. That is correct, but it is a limited Federal involvement, in that it would be the establishment and enforcement of disclosure rules. That is not a very micro approach. It still gives the States most of the latitude that they currently have, and it shifts to the consumer a large portion of the burden of helping to regulate the industry for all of us.

Senator EXON. I thought maybe you heard me say earlier in the morning that if we have some kind of—I do not know what it should be called—minimum standards, or guidelines, or something, while maintaining the implementation and control of that at the

State level. Are those something along the lines that you are thinking?

Mr. WEISS. There are two kinds of minimum standards that we are talking about here. One minimum standard is the one that seems to have been discussed up until now, which in effect says that insurance companies have to remain within certain limits of risk or financial health.

The standards that I am referring to are disclosure standards, and if you establish those, then the consumer goes into the policy with his eyes open and you can allow more latitude than you would have otherwise with respect to the financial standards.

Senator EXON. In other words, that is into the area of more full disclosure about what the policy does and does not do?

Mr. WEISS. That is correct—what the costs are, what the benefits are, and what the risks are to the consumer along a wide variety of parameters.

Senator EXON. With regard to solvency of the insurance industry—and we kind of lop this all in together, but the insurance industry is a tremendously big field with lots of different specialties.

For many years, and I think probably this is still the case for the most part, the life insurance industry has been the most easily provable from the standpoint of solvency, since a life insurance company does not have all of the variable risks and escalating costs, as do other types of insurance such as casualty insurance companies, with the skyrocketing costs of fixing an automobile, for example, to the health care industry.

That certainly is in some difficulty today, with being unable in many instances to increase their premiums fast enough to cover the ever-increasing costs of providing the services that they do.

Is it not true, though, that since life insurance companies and their actuaries have evidenced in the past that they have a very good hold and very good understanding on when they are going to pay out, and in what amount, because they know pretty well what their average policyholder—how long that policyholder is going to pay in, and then when they have to start paying out with death.

Is it not true, then, that life insurance companies basically should be the easiest and have the least regulation, except for, as in the case of Executive Life that we are talking about today, their investment policies, and investment policies go astray, it seems to me, in life insurance companies only because some of these entrepreneurs decide it is something to play with and gamble with rather than to have a solid life insurance company, as we generally expected them to be over the years, with a return on investment, but not something that would be a huge return on investment, that it seems to me like junk bond type financing has been a part of.

Mr. WEISS. But you know, the junk bonds are more a symptom than a disease. They stem from the competitive pressure of the marketplace to promise higher yields in the earlier part of the decade.

Why did the consumer put that pressure on the insurance company? Because he did not know better. Because he did not know about the risks. If that had been disclosed ahead of time, I do not think insurance companies would have wanted to, or would have needed to get into junk bonds and other speculative investments in the first place.

Senator EXON. That is a good point, and I think it is well made, and it should be well understood that a lot of the problems that we are in today is the economy in which we live, where everybody is demanding more from someone else without making much of a sacrifice themselves.

The basic idea of insurance is not to make money. The basic idea of insurance is for protection, but we seem to believe that, whether it is social security or whether it is life insurance it is something that is going to be good for me at some time or other, when the basic thought behind life insurance, at least, is to provide for others, not yourself.

Mr. WEISS. The issue that is key in the insurance regulation today is to try to prevent solvency—prevent insolvency, excuse me. [Laughter.]

Senator EXON. Yes. We have enough of the other.

Mr. WEISS. That is fine. That is a worthy goal. However, when it is carried to the extent of trying to create a Garden of Eden environment for insurance companies to continue doing business regardless of the economic realities, then it leads to problems such as we see today.

Senator EXON. For my last question, I would go back to you, Mr. McCartney.

You heard me read, I think, the story that I referenced from the Los Angeles Times of mid-April with regard to some actions by the leadership of the Executive Life Insurance Co. and the related Executive Life Associated with regard to the transfer of some funds that seemed to accrue a very healthy personal profit to a very few individuals by transferring capital back and forth among some of the companies that they controlled. I am not sure of the date that happened, but I understand it was sometime last year in the calendar year 1990.

On that particular transaction, were you and your agency in Nebraska advised of this? Did you know about this transfer, or not?

Mr. MCCARTNEY. Senator Exon, I want to be sure I understand this. Is this the transaction that basically guaranteed some golden parachute payments for Fred Carr and some of the others?

Senator EXON. Well, let me read this briefly again, then. It is from the Los Angeles Times. It says:

> Top officers in the First Executive Corp. reaped windfall profits only months before the California regulators took over the company's biggest subsidiary, Executive Life Insurance Co. of California.

I am continuing to quote:

> Five months before the Executive Life was seized by the California Life Insurance Department, four of First Executive's top officers cashed out of a limited partnership called "Executive Life Associates," which had investments in First Executive headquarters buildings in Los Angeles over the past several years. First Executive Chairman Fred Carr earned a net profit of $1.2 million on his investment of less than $1.5 million, according to the company.

Does that reference it sufficiently for you?

Mr. MCCARTNEY. That is different from the other issue which, when we found out about it—we found out about it from Commissioner Garamendi, and as soon as that was discovered the company agreed to unwind that transaction.

I was not aware of this until today, but again, this is at the holding company level, and if something goes on at the holding company level that does not directly affect the life insurance companies, that is generally not something that the holding company officers are required to inform regulators about.

Senator EXON. Well, Mr. Chairman, thank you for your comment. This leads me to a great deal of concern here.

It seems to me that with the creation of a life insurance company and then a holding company on top of that which we are replete with in the banking industry, it seems to me that if somebody can manipulate the assets of a life insurance company by forming a holding company over here to which you, as a regulator, have no control over, we have got to do something, or else the life insurance companies are going to be bled dry of cash reserves by those kinds of activities. What are we going to do about it?

Mr. MCCARTNEY. Senator Exon, there are very severe and strict limitations on the abilities of holding companies to take money from insurance company subsidiaries. We control dividends. Any kind of extraordinary dividend outside the normal course of business cannot be made without the prior approval of the Insurance Commissioner.

This sounds like a transaction that probably should have been disclosed to the stockholders of First Executive Corp. in the 10(k) filed with the SEC, but it had to do with operations at the holding company level.

Now, it is true that Executive Life would be making some rent payments, but as long as those rent payments were reasonable in relation to their use of the building, regulators would not have any concern beyond that.

At the holding company level, if some of the holding company level officers have cut some sweetheart deals with property that really is perhaps utilized by holding company operations, that is a different story, but there are very strict—very, very strict requirements and provisions relating to the ability of funds to be transferred between affiliates and funds to be moved upstream to the holding company.

Senator EXON. Well, supposedly, Mr. McCartney—and I am only reading this article and associated articles related with it—this deal that I just referenced supposedly involves an exchange of capital between First Executive or some of their subsidiary organizations or holding company with the Lincoln Liberty Life Insurance Co. of Nebraska, which is a Nebraska-regulated body. Are you aware of any of that, or have you ever heard about it before?

Mr. MCCARTNEY. Well, the one that I am aware of is the transaction where the subsidiaries were going to guarantee the golden parachutes, and as soon as we found out about that, that was reversed.

If what you are talking about today is similar to that or the same transaction, that has been reversed. If this is something different, I would like to know about it, Senator.

Senator EXON. We will check into it, and I appreciate it. I thought you would, and I appreciate your testimony, Mr.

McCartney, and I appreciate your being here also, Mr. Weiss, and thank you, Mr. Chairman.

Senator **Bryan**. Thank you very much, Senator Exon.

Gentlemen, we appreciate your testimony today. we are going to keep the hearing record open for some of our colleagues who may want to address some additional questions to you.

We thank you very much, and this committee stands adjourned.

[Whereupon, at 12:53 p.m., the committee adjourned.]

FAILURE OF THE EXECUTIVE LIFE INSURANCE CO.

THURSDAY, MAY 9, 1991

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
Washington, DC.

The committee met, pursuant to notice, at 2:20 p.m., in room 253, Russell Senate Office Building, Hon. Richard H. Bryan, presiding.

Staff members assigned to this hearing: Moses Boyd and Linda Lance, professional staff members; and Alan Maness and Sherman Joyce, minority professional staff members.

OPENING STATEMENT BY SENATOR BRYAN

Senator BRYAN. Let me welcome you to continuation of the Senate Commerce Committee's examination on the failure of Executive Life Insurance Co. And to preface my comments, let me apologize to the witnesses and all of you for the late commencement of this hearing this afternoon. As you all know, we had a rollcall vote scheduled shortly after 2 o'clock. And I fully expect that some of my colleagues will be joining us for this hearing later on.

This, as those of you who have been following these proceedings know, is the third in a series of hearings this committee will hold on the question of solvency in the life insurance industry. On Tuesday of this week, we heard testimony from the California and New York State insurance regulators, both of whom placed Executive Life of California and Executive Life of New York, respectively, in conservatorship in their respective States in mid-April.

But the collapse of the Executive Life companies represent the largest Government seizure in the history of the insurance industry, a value of more than 300,000 policies is in doubt, and the fate of these policyholders is clouded with uncertainty.

As we confirmed in our hearing on Tuesday, there was a total breakdown of the regulatory system. Early warning signals either did not work or did not exist. Top national insurance rating firms continued to give Executive Life high marks as it moved ever closer to insolvency. The major accounting firm of Deloitte Touche gave Executive Life clean audits year after year, only to have the key auditor on the company's account take a $300,000 job with Executive Life shortly after completing the audit of Executive Life.

Today, we turn to the victims, the people who put their money into Executive Life because they wanted to provide a monthly check for their retirement, or to provide insurance benefits for the support and protection of their families.

Let me read to you now from a letter that I received from a Nevada resident, who holds one of more than 2,300 Executive Life policies bought by Nevadans. And I quote:

> I took out a substantial policy with Executive Life in 1985, so I paid a lot of hard-earned money to them. At this point, I am very worried because it looks like a major portion of my plans for my wife's and for my family's future have gone up in smoke.
>
> Because of my age, 67, and having had open heart surgery, I am no longer insurable. I am not smart enough to have a solution to this problem, but I hope you and your colleagues will be able to find a way.
>
> Had the company informed us of their problems in time, other arrangements might have been possible. At this late date, we seem to be stuck, and there is no one to protect our future, but you.

I am sure that that letter is an example of the type of letter that all of my colleagues are receiving. The people who purchase insurance do so because they need the security and protection that insurance has traditionally provided. With Executive Life, they receive neither security nor protection.

It would be inaccurate to suggest that the entire life insurance industry is on the verge of collapse. There are many well-run, financially sound companies. However, I am also persuaded that the problems of Executive Life are shared to some extent by other life insurance companies which chose the fast money route to junk bonds.

Our first witness this afternoon, Mr. Donn Sigerson, is one of the victims of the collapse of Executive Life, and is the president of Executive Life Support Network composed of other victims who hold Executive Life or other types of insurance coverages.

In addition, we have the attorney for former employees of Pacific Lumber, a company whose once profitable pension plan was forced into the hands of Executive Life after a leveraged buyout. Despite the repeated warnings of the Pacific Lumber treasurer that Executive Life was a bad risk, the new owners turned the federally insured pension plan with a $55 million surplus into an Executive Life annuity. Now the monthly benefits of more than 2,000 employees of that company are in danger.

The consequences of the failure of Executive Life are not just a problem for California and for New York. Executive Life policyholders can be found in all 50 States, and as another of our witnesses will testify today, if a buyer is not found and Executive Life is determined to be insolvent, the losers will not only be the policyholders, but all of us. If Executive Life is declared insolvent, State guarantee funds which are established in 47 States, soon to be added by another later this year, will be tapped to pay part of the value of Executive Life's policies for policyholders in their States.

However, it is highly unlikely that anyone will collect the full value of their policy. The State guarantee funds will come from assessments on all insurance companies doing business in those States. To recoup, the companies who have been so assessed, the healthy companies, will pass on higher premiums—premiums to their policyholders. And the companies in many States will be allowed to offset those assessments against their tax obligation to the State governments and to the Federal.

There are those who advocate Federal regulation of the insurance industry. It is obvious that State regulation, in the case of Executive Life, failed. While we must tighten controls, accountability, and disclosure requirements for the insurance industry, how to do so and what course of action we take remains to be determined. Whatever approach is taken, we must act quickly, and I hope that we can do so with the full support and cooperation of the insurance industry.

The committee intends to take a closer look at the tighter regulatory standards which have been proposed by the National Association of Insurance Commissioners. Soon, the General Accounting Office will be issuing an analysis of the NAIC recommendations, and we will examine those carefully. In addition, the committee plans to hold a hearing on the role of those who provide information which consumers use and rely upon to judge the financial stability of individual service companies. Insurance rating services, and accounting firms must provide financial data beyond question, and the action of their employees must be beyond reproach.

These standards appear to be in question in light of the history developed in Executive Life. And finally, I am personally requesting a full investigation of the collapse of Executive Life of California and Executive Life of New York, and the role of its parent company, First Executive, by the U.S. Department of Justice. If laws were broken, someone must be held accountable. If criminal acts were committed, those responsible must be punished. And if unethical behavior is involved, those so involved must be exposed. And most of all, we must use the full force of the Congress and the Federal Government to step in, now, early to protect the consumers and the taxpayers from future financial ruin.

Our first panel this afternoon will consist of Mr. Alfred Sigman, of Sigman & Lewis; Mr. Donn Sigerson, president of Executive Life Support Network; and Mr. Eden D. Sarfaty, president of NOLHGA, the Guaranty Associations. Gentlemen, if you will join us at the table. And we will begin as soon as Mr. Sigerson is comfortably placed. And I am told that he will be joined by his wife, that will be sitting behind him, because he may have some difficulty with the microphones that we have.

Gentlemen, welcome to the hearing. Mr. Sigerson, do I pronounce your name correctly, sir?

Mr. SIGERSON. Yes, sir.

Senator BRYAN. We begin with you, sir.

STATEMENT OF DONN SIGERSON, PRESIDENT, EXECUTIVE LIFE SUPPORT NETWORK

Mr. SIGERSON. My name is Donn——

Senator BRYAN. Could you pull that microphone just a little closer to you so that we can all hear you, and those in the audience might have the benefit of your testimony?

Mr. SIGERSON. My name is Donn Sigerson. I am here as the founder and president of the Executive Life Support Network. It is a distinct honor to have the opportunity to be here before this group.

I received an invitation Tuesday afternoon, in the late afternoon, in Los Angeles. At 78 years old, when you want to take little snooze, you say you are in conference. But when the call came through I managed to get out of that conference and arranged to come in.

I am a 10-year annuity holder. My anniversary date is May 20, 1991. On this anniversary date, 11 days from today, my contract guarantees me $456,000 lump sum. I am 78 years old in June. I have an arthritic neck, two jammed vertebrae, two other vertebrae that have moved sideways from the others like this. The only reason I am able to be here today is a miracle drug called "Meclomen." Every specialist that I have seen in the last 3 or 4 years has said "That is the worst neck I have ever seen," or "I have never seen a worse neck." It is not a question of if I will have major surgery, it is a question of when. I have x-rays every 2 months. If the spinal cord moves too far, it cuts my spine.

If I may, I would like to place what I have said to you in perspective compared to thousands upon thousands of other investors with Executive Life. Compared to them, I am in the prime of my life, the luckiest guy alive, and have nothing to worry about. So many others are literally leading a day-to-day existence, going to bed for a painful night not sure they will be able to see another daylight. When you do not have money, in many cases you do not have hope. These are people who have labored and labored and saved all of their lives, specifically not to be in this dilemma at this stage of their lives.

When I invested my hard-earned money 10 years ago, Executive Life was a health company, rated tops in security in the industry. That is why I chose it. I did not want to risk the money I was planning on spending on my retirement.

Well, we know what happened in the meantime. The management of Executive Life took a lot of risks. They invested in things I would never have touched, they gambled, effectively, with my money. I would have just as soon as taken it to Las Vegas myself. Meanwhile, nobody let me know what they were doing. I trusted, perhaps foolishly the manager of that company, and even worse, I trusted my Government to watch over their actions for me, expecting them to be mindful of those who abuse their power over ordinary citizens. No one told me a thing until April 2, 1991.

On April 2, 1991, a story appeared in the Los Angeles Times about Executive Life's precarious position. I spent the next days doing research. I talked to nearly everyone in the State insurance commission including numerous deputy commissioners. The rest of the time I spent at Executive Life. I talked with every official there except Fred Carr. I had two long conversations with Alan C. Snyder, the new president—only after making five or six calls a day to him would he answer my call the second or third day. Mainly, I think, his assistants were going nuts over my calls.

On April 10 at 4 p.m., after the study that I made, the officers of Executive Life said that if I cashed in my policy at cash value, they would guarantee that I would get my money. I spent so much time at Executive Life, I met at least one-half of their supervisory personnel, so I was trying to analyze just exactly what was going on. As an exbusinessman, I had some sense, as I talked to them, about what was going on.

There was an inside joke they told me about, Executive Life at the time they waited until security swept the building at night, and guaranteed management that Sigerson was really gone for the day before they turned off the lights.

After much biting of the bullet, I became convinced I cold not gamble on Executive Life being alive on my anniversary date almost a month away. I would have collected $456,000 at that time. On the verbal guarantee that if I surrendered my annuity on April 10, I would send my surrender annuity value—cash value—$370,000 in a few days. Not the $456,000 due 1 month later with the sure knowledge that the operation on my neck was not a question of if, but when, I signed away $86,000.

Word of this reached CBS and I was on the Dan Rather show for a few minutes on TV on April 10. The news brought many phone calls and letters for advice and/or sympathy. Losing the $86,000 was the good news. On April 11, 11:30 a.m., the State took over Executive Life and stopped all annuity checks. Mine included. That was the bad news. But despite my quick action, I now stand to lose everything.

And I will not read the certification there, but in 1981, May 20, I invested $141,000 in the pension plan. I started the Executive Life Support Network to try to organize, empower, and inspire the hundreds of thousands of our fellow investors. And through those efforts, I have heard from hundreds and hundreds of people who are frightened, upset, and desperate.

We are talking about 400,000 people, nearly 300,000 in California and 100,000 in New York, and others scattered throughout the rest of the States in the Union. People who are 65 years old are discovering that they cannot retire because their means of support, many who were relying on annuities from Executive Life, are just being able to survive—400,000 people have lost their security, their peaceful retirement, their lifetime medical payments, and sometimes, their very lives.

You see before you one man who is in a situation like anything had never occurred. But in me you are also seeing 400,000, all of whom share my dire position. We have been let down by our Government and by those we employed to watch over our funds. And we need your help now to right these wrongs, and to return to us that which should never have been taken from us. I cannot believe the Government, our representatives and officers of the executive branch begin to understand the latent anger of these 400,000 investors and their immediate family of 1.5 million additional people, and perhaps another 2 million of their close friends. And we need your help to right these wrongs, to return us that which should have never been taken.

There was a piece in the Los Angeles Times which asked the question, am I angry. "'Of course I am angry,' said Donn Sigerson, a 77-year-old policyholder who had been trying to withdraw his funds from Executive Life when the State insurance commissioner sought a court order to put the company in conservatorship."

I came in to surrender a policy before the regulators took over, and now they are hold up my payment. I do not think anything the Insurance commissioner has said would indicate to me that my money is now safe. "Sigerson is so irritated about his inability to get factual information from regulators, that he is trying to form a policyholder group that would talk to State officials en masse. 'I think we policyholders need a single voice so that the commissioner knows how we feel,' Sigerson said. 'Divided we have nothing. As an organization, I think we will at least be able to get information more easily.'"

The response from investors of Executive Life was enormous in letters and phone calls to this announcement. It continued day to day.

On May 2, we put out our first newsletter. We wrote prototype sample letters to the President, Congressmen, and State officials, to give the other shareholders something to think about in their own letter. We also enclosed names and addresses of every elected State official in California and all Congressmen and President Bush.

We have had this dream that if we worked hard, were thrifty, and put our money in pensions, insurance, and retirement funds, we could then enjoy security, if not comfort, in our old age. As it is now, this has turned out to be just pie in the sky.

A new definition has had recent broad coverage. Some slick gimmick to have us kid ourselves; that is, we older people. The term is "seniors." That may be, but in reality we are just very old and very tired.

It takes cash money to take care of yourself and not be subjected to the ultimate indignity of Government handouts. Never enough, never on time.

Old age is being alone and depressed with yourself all the time. You are living on less, below a subsistence level. You do not know whether you will see another daylight. It is not knowing whether anyone really cares.

There are too many Americans in this situation. We do not belong in this group. We made and saved sufficient funds to live to the end of our lives in security, if not comfort. Now our great democracy has stolen this from us, through laxity, ignorance, or not caring.

We are mad, and we are angry. We want to make it hurt those who have betrayed us. That is what anger is all about. We are proposing, you might say going so far as demanding, that every elected or appointed official, hold open house when they are home so that they may better understand their misdeeds. They, in large part, are responsible.

Only in this way can we correct the affliction that haunts every American now. No one has any faith in investing for their future. There is no hope on the return of their money from Executive Life.

We have no choice to believe our Government could guarantee we would receive our money. You owe us, our Congressmen and Senators. You lost us our old-age security.

Let us see a new breed of public servants that look after the law. You owe us. It is our belief and hope you will take care of your invoice. It is in arrears. Thank you.

[The prepared statement of Mr. Sigerson follows:]

PREPARED STATEMENT OF DONN SIGERSON

It is a distinct honor for this citizen to be invited to appear before this distinguished group of Senators.

I received an invitation Tuesday afternoon telling me the committee wished to hear from an investor in Executive Life. I am a 10-year annuity holder. My 10-year anniversary date is May 20, 1991. On this anniversary date, eleven days from today, my contract guarantees me $456,000 lump sum.

I am 78 years old in June. I have an arthritic neck, two jammed vertebrae and two other vertebrae that have moved sideways out of alignment with the rest of my vertebrae. I have suffered mild to medium arthritis pain since I turned 70 * * * what I would not gave to be 70 again! With the last 4 to 5 years it has become severe and I take the latest miracle drug Meclomen without which I wouldn't be here today. Every specialist I've seen either says "That is the worst neck I have ever seen" or "I've never seen a worse neck." It isn't a question of "IF" I'll have major surgery it is a question of "WHEN". I have x-rays every two months.

If I may, I'd like to place what I've just said to you in perspective. Compared to thousands upon thousands of other investors with Executive Life, I am in the Prime of my Life—the luckiest guy ever, and have nothing to worry about.

So many others are literally leading a day-to-day existence, going to bed for a painful night not sure whether they will live to see another daylight. When you don't have money, in many cases you don't have hope—and these are people who labored and saved all their lives specifically not to be in this dilemma at this stage of their lives!

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TELC 04/04/91 09:36:45       ANNUITY STATUS INQUIRY                          TE130L00
PT T : 120635
AN..TY: C01087608D           STATUS: A W/C: 3  CURR INT:  6.75 SSN: 553-22-8156
BIRTH: 06/23/1925  SEX:  M   OWN CD: 1 LOB: GQ DOWN I/O: 12.25 STATE: CA
                                           BONUS RATE:  0.00
PREMIUM PAYMT:    141,119.51   ISSUED: 05/20/81 ANNUITY TYPE :
AMT WITHDRAWN:           .00   MATURE: 05/20/91 ANNUITY BASIS:              .00
REM PRINCIPAL:           .00   VALUED: 03/31/91 ORIGINAL ISS  : 00/00/00
ANNUITY VALUE:    370,667.60   CHANGE: 03/22/90 ORIGINAL POL#:
MKT VALUE ADJ:           .00     TYPE:          AUDIT STATUS  : AUDITED
SURRNDR VALUE:    370,667.60   --------COMMENTS---------

---ANNUITANT-------------              ----------- A G E N T   I N F O -------
                                                AGT-1 AGT-2 AGT-3 AGT-4
                                          AGT NO: E8803
---OWNER-----------------
SIGERSON, DONN C
10601 WILSHIRE BLVD #402
LOS ANGELES, CA 90024

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MESSAGE:  TE130L00-PLEASE ENTER POLICY NUMBER TO CONTINUE
_ (= T-TERM 1-MENU 2-SUB MENU           5-CASH FLOW 6-AGT  7-POL ACCT 8-SRV STAT
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II

STATEMENT OF BENEFIT INFORMATION PAGE 1 OF 2

EXECUTIVE LIFE INSURANCE COMPANY
11444 WEST OLYMPIC BOULEVARD
LOS ANGELES, CALIFORNIA 90064
TELEPHONE: (213) 312-1000

FOR ADDITIONAL INFORMATION ABOUT
THIS CERTIFICATE PLEASE CONTACT:

PREPARED FOR: DONN C SIGERSON

PREPARED ON: APRIL 4, 1991

CERTIFICATE NUMBER: C01087608D

THIRTY DAY RIGHT TO CANCEL

WITHIN 30 DAYS AFTER THIS CERTIFICATE IS FIRST RECEIVED, IT MAY BE CANCELLED FOR ANY REASON BY RETURNING IT TO THE HOME OFFICE OF THE COMPANY. THE RETURN OF THIS CERTIFICATE WILL VOID IT FROM THE BEGINNING. THE COMPANY WILL REFUND THE SINGLE PREMIUM PAID FOR THIS CERTIFICATE, LESS ANY WITHDRAWALS, WITHIN TEN DAYS AFTER RECEIPT OF THE NOTICE OF CANCELLATION AND THE RETURNED CERTIFICATE.

-CERTIFICATE INFORMATION-

PLAN NAME: SPDA SAVANNUITY
- SAVANN
PLAN CODE: 635
ANNUITANT: DONN C SIGERSON

FORM: 632-635
SEX/ISSUE AGE: M/55

ISSUE DATE: MAY 20 198
MATURITY DATE: MAY 20 19

-GUARANTEED AND PROJECTED VALUES-

EAR	SINGLE PREMIUM	GUARANTEED CASH VALUE END OF YEAR	PROJECTED# CASH VALUE END OF YEAR	GUARANTEED END OF YEAR SINGLE SUM DEATH BENEFIT*	PROJECTED# END OF YEAR SINGLE SUM DEATH BENEFIT*	GUARANTEE INTEREST RATE
1	$141,119.51	$152,522.67	$152,522.67	$161,229.04	$161,229.04	14.25%
2	$0.00	$163,212.16	$175,914.99	$170,902.78	$184,204.18	6.00%
3	$0.00	$174,635.30	$202,876.96	$181,156.95	$210,453.27	6.00%
4	$0.00	$186,841.65	$233,950.91	$192,026.37	$240,442.87	6.00%
5	$0.00	$199,884.09	$269,761.27	$203,547.95	$274,705.97	6.00%
6	$0.00	$213,818.98	$311,026.91	$215,760.83	$313,851.57	6.00%
7	$0.00	$228,706.47	$358,575.42	$228,706.47	$358,575.42	6.00%
8	$0.00	$242,428.86	$409,672.42	$242,428.86	$409,672.42	6.00%
9	$0.00	$256,974.60	$468,050.74	$256,974.60	$468,050.74	6.00%
10 Year	$0.00	$456,163.38+	$534,747.97	$456,163.38+	$534,747.97	6.00%

+ THE $456,163.38 WILL BECOME A MINIMUM OF $456,163.37 IF THERE ARE NO WITHDRAWALS, USING 14.25 PERCENT IN YEAR 1 AND THE BASE FACTOR OF 12.25 PERCENT IN YEARS 2 THROUGH 10.

# BASED ON 14.25 PERCENT INTEREST EACH YEAR. THE AMOUNTS SHOWN ARE ILLUSTRATIVE AND ARE NOT GUARANTEED

* SEE TOP OF PAGE 2

RECEIVED
APR 10 1991

APR 10 1991

II

DEFERRED ANNUITY WITHDRAWAL/SURRENDER REQUEST

Executive Life Insurance Company
11444 W. Olympic Blvd., Los Angeles, CA 90064
POSTAL ADDRESS
P.O. Box 6090, Inglewood, CA 90312-6090

PLEASE PRINT

INSTRUCTIONS. The annuity Owner(s) may use this form to request action from the Company. Please check (✓) the appropriate squares, and provide the necessary information. (Send to the above address, ATTN.: Deferred Annuity Dept. Phone 213/ 312-1000.)

DATE	ANNUITANT	OWNER(S)	ANNUITY NO.
4/10/91	DONN C. SIGERSON		CO 1 9 8 7 6 0 8 D

I. I hereby request the Company to remit payment from this annuity as indicated below:

☐ **1. Penalty-free Partial Withdrawal:** Withdraw the full amount available without penalty as defined in the annuity.

☐ **2. Partial Withdrawal:** Specify withdrawal amount $ ________
NET WITHDRAWAL AMOUNT

Deduct this net withdrawal plus any applicable charges as defined in the annuity, from the annuity value.

☒ **3. Full Surrender:** The ORIGINAL ANNUITY must be submitted for surrender. (If the annuity cannot be located, complete the reverse side of this form.) Withdraw the full amount of the Cash Value as defined in the annuity.

A. Will the proceeds of this surrender be used to purchase another annuity under the Internal Revenue Code provisions regarding tax-free transfers of funds?
☒ No ☐ Yes

B. Will the proceeds of this surrender be used to purchase another annuity from Executive Life Insurance Company?
☒ No ☐ Yes (If yes, an application for the new annuity must be submitted.)

II. WITHHOLDING ELECTION:

1. Please withhold ☒ 0% ☐ 10% ☐ Other (Specify % or $ amount) _____ for Federal and appropriate State Income Tax from this distribution if applicable. I understand that I am liable for payment of any taxes on the taxable portion of the distribution. I also understand that I may be subject to tax penalties under the estimated tax payment rules if my payments of estimated tax and withholding are not adequate.
2. Social Security or Tax ID No. 553 . 22 . 8156
3. Owner's Address 10001 WILSHIRE BL. #407 LA CA 90024

III. PAYEE

Please make the check payable as follows:
DONN C. SIGERSON

Please send check to following address:
10001 WILSHIRE BL #407
LA CA 90024

Is the above the Owner(s)' current address?
☐ No ☒ Yes

Is there a daytime telephone number where we can contact you in case of a question on your request?
213/420-3588

IV. AUTHORIZATION*

X Donn C. Sigerson
SIGNATURE OF ANNUITY OWNER

X ______
SIGNATURE OF ANNUITY OWNER

State of ______) ss.
County of ______)
On this ______ day of ______, 19___,
before me personally came ______
and ______, to me known to be
the individual(s) who executed the above request.

My Commission expires ______.

______
NOTARY PUBLIC

RECEIVED
APR 10 1991
CONSUMER INFORMATION DEPT.

*TO AVOID DELAYS, PLEASE HAVE THE OWNER(S)' SIGNATURE NOTARIZED. THERE MAY BE ADDITIONAL REQUIREMENTS FOR CORPORATE OR CUSTODIAL ACCOUNTS. IF THE ANNUITY IS COLLATERALLY ASSIGNED OR IF AUTHORITY UNDER A POWER OF ATTORNEY IS EXERCISED. PLEASE CONTACT THE COMPANY FOR ASSISTANCE.

Received by Cary A. Filsinger
Cary Filsinger
Executive Life
4/10/91

1368 11/88

When I invested my hard-earned money ten years ago, Executive Life was a healthy company—rated tops in security in the industry That's why I chose them. I didn't want to risk the money I was planning on spending my retirement on.

Well, we know what happened in the meantime. The management at Executive Life took a lot of risk with my money. They invested in things I would never have touched, they gambled, effectively, with MY MONEY. I would just as soon have taken it to Las Vegas myself. Meanwhile, nobody let me know what they were doing. I trusted, perhaps foolishly, the management of that company, and even worse, I trusted my government to watch over their actions for me—expecting them to be mindful of those who abuse their power over ordinary citizens. No one told me a thing, until April 2, 1991.

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After much biting of the bullet I became convinced that I could not gamble on Executive Life being alive on my anniversary date for me to collect my $456,000. On the verbal guarantee on the 10th of April of two or three top officials that if I surrender my annuity I would receive $370,000 in a few days—not the $456,000 due a month later with the sure knowledge that an operation on my neck was not a question of IF but WHEN, I signed away $86,000.

Word of this reached CBS and I was on the Dan Rather show on April 10, and in the local TV, radio and newspapers.

The news brought many phone calls and letters for advice and/or sympathies. Losing the $86,000 was the good news on April 11 at 11:30 am. The State took over Executive Life and stopped all annuity checks such as mine—that was the bad news. Despite my quick action I now stand to lose everything.

And I am not alone. I've done my share to try to contact others in my situation. I started the Executive Life Support Network to try to organize, empower and inspire the hundreds of thousands of my fellow investors. And through those efforts, I've heard from hundreds and hundreds of people who are frightened, upset, and desperate. We are talking about 400,000 people: nearly 300,000 in California and 100,000 in New York and others scattered in every State of the Union, who have all suddenly found the rug pulled out from under them. People who at 65 years of age are discovering that they can't retire because their company pension plan invested in Executive Life. Widows who have no means of support, many more who were relying on annuities from Executive Life merely to survive. 400,000 people who have lost their security, their peaceful retirement or their lifeline medical payments, in some cases, their very lives.

You see before you one man who is in a situation he wishes like anything had never occurred. But in me you are also seeing the 400,000 who all share my dire position. We have been let down by our government and by those we employed to watch over our funds. And we need your help to right these wrongs, and return to us that which should never have been taken from us.

can't believe the government, our representatives and officers of the E1xecutive Branch begins to understand the latent anger of the 400,000 investors (and their immediate families of 1½ million and another 2 million of close relatives) are feeling all the time, every waking hour!

Almost all of the several hundred I've talked to and heard from are very angry. I have heard this so much it is scary. I am becoming more angry by' the day as I hear of the out and out betrayal we all feel. We are gradually focusing this on our President, Congress and down the line.

In my humble opinion unless the government gets active there may well be many acts of violence. Today people are just beginning to understand the enormity of their conditions. In 6 months to a year it will begin to peak. Because of many requests and opinions I've heard and much public attention, I believe and know we have to become a very active and dynamic force to obtain the attention of our elected officials.

On April 25th at 10 am. I held a press conference in the patio of the Executive Life. The coverage came from every major network news along with local radio and TV stations and news publications. In all cases they also covered/videotaped a placard we had in front of the podium. This poster contained our hotline (213) 896–9566 and our mailing address, P.O. BOX 24070,Los Angeles, CA 90024. The response was enormous. (Note: our first caller came in at 11:25 a.m.)

Newsletter #1 **May 1991**

Executive Life Support Network

.O Box 24070, Los Angeles, CA 90024 **(213) 896-9566**

Welcome to the **Executive Life Support Network** -- an organization created by and for those of us who placed our money into Executive Life in good faith -- and who are now faced with the fight of our life to get that money returned to us. The only realistic chance of any return of those funds is to join together (acting as individuals we will neither be heard nor heeded) and to apply our combined might to demand and to fight for the return of that which has been taken from us. To utilize every means available to us in a democratic society: letters, phone calls, meetings, demonstrations, and legal action.

A bit of background first. Donn Sigerson, a 77-year-old retiree, had been anticipating his policy's ten-year anniversary on May 20th, on which date Executive Life was due to pay him a lump sum of $465,000. When the mismanaged company suddenly collapsed, Sigerson found himself, like hundreds of thousands of others, powerless to get to his hard-earned retirement funds.

So two weeks after the government seizure of Executive Life Insurance, Sigerson and others fought back. Calling a press conference at Executive Life on April 25th, he announced the formation of the Executive Life Support Network. The press conference was to serve as a beacon to inspire and act others in his situation. Deputy Insurance Commissioner Tom Epstein attended as a representative of Commissioner Garamendi's office and welcomed our efforts.

In every way, the response was overwhelming. The press conference appeared on nearly every television station, including CBS, ABC, NBC, CNN and many local stations. Numerous radio stations broadcast the event, and several large newspapers carried the story. The word was out -- the investors of Executive Life would not take this lying down.

The original Executive Life Support Network Hotline (**213/896-9566**) was established to help members organize, and within hours it was swamped with hundreds of calls, coming in waves that jammed the telephone circuits. People from across the country dialled in to get information on how to join and how they could help. The troops were mobilizing!

Sigerson's next step was to establish a firm legal framework for the fledgling organization. The Executive Life Support Network became a legal entity -- a DBA, with a non-profit foundation status pending. With a seed loan of $1,000 from the Sigersons'own savings, the organization is gearing up for the fight. Meetings are being planned, a bulletin created, and a battle plan devised to spread the word: **Investors Unite!**

More media attention is being focused, as Donn Sigerson receives requests for appearances on talk shows and meetings across the country. When the Crisis began, Sigerson didn't know the name of a single investor in Executive Life other than himself -- now he can list hundreds, and in the weeks to come, thousands.

There is strength in numbers. Individually, there's not much we can do. But when a hundred thousand angry constituents start banging down the doors of their government representatives, start demanding what is owed them and insist their best interests be looked after, ***things will start to happen***.

HOW IS THIS ALL BEING FINANCED?

An important question -- bulletins, meetings and legal consulation cost money, and someone must foot the bill. Though it would be relatively easy to accept money from corporate or legal groups interested in a "slice of the pie", that would weaken our mission. We can't expect others to take care of things for us (we've learned that lesson well!) so it's vital that we fund this effort ourselves, from our own resources.

A 12-person Finance Committee, representing Executive Life investors from all walks of life, is forming to oversee the disbursement of all Support Network funds.We need volunteers--please contact us.

And now for the important part: What are we going to do to regain control of our assets in Executive Life?!?

THE FIRST MEETING OF THE EXECUTIVE LIFE SUPPORT NETWORK:

May 17th, time and location to be announced.

(Check our hotline for the latest information.)

Special guest of honor:

California Insurance Commissioner John Garamendi.

This will be our first and most important mass meeting. We will pack a large auditorium with concerned and angry investors, and Garamendi himself will be on hand to tell us his next steps for rescuing our assets. Here's our chance to voice our problems and get our questions answered, as well as to put on the biggest show we can for the media. The stronger the turnout, the stronger the message to government officials on both the state and federal level -- we want this spectacle to be seen nationwide, since investors are scattered all across the country. We will make it abundantly clear and obvious that the lives of hundreds of thousands of people have been put in jeopardy. We will show the country beyond a doubt that our situation is desperate, but that we're not giving up without a fight. And we'll show our legislators, our governor, the IRS and the President that the defrauded investors of Executive Life are a political force to be reckoned with.

We know that many of our fellow investors, due to health or distance, will not be able to attend our first meeting with Commissioner Garamendi. For this reason we will be videotaping the meeting, and will make copies available for $10 per tape for those who are interested. Please send inquiries to the Executive Life Support Network, P.O. Box 24070, Los Angeles, CA 90024.

WRITE LETTERS TO YOUR ELECTED GOVERNMENT OFFICIALS

Right now, every single investor must write to our elected officials, both State and Federal. In this lies our only strength and hope that we will ever see our money again. Please! Send copies of your letters or wires to us at P.O. Box 24070, Los Angeles, CA 90024 as a guarantee that it will be seen and heeded by the appropriate officials. This action guarantees your letter will not be casually brushed aside or tossed in the wastebasket -- we will personally hand-deliver them if necessary.

There are two hard, salient points that must be addressed:

1. On Jan. 1st our state government passed a law to protect California investors by shielding a percentage of their investments. This is our single best chance of saving something from the Executive Life debacle. However, there is still a mighty "if". If Commissioner Garamendi should find that Executive Life was "impaired", i.e. not solvent, we receive nothing. Until this ruling is settled, our assets are in danger! We must write to our elected state officials to stress it is our plea and prayer that Executive Life be found unimpaired as of Jan 1, 1991.

2. Within days of Executive Life's takeover by Commissioner Garamendi and the State, the IRS announced the planned seizure of $643 million in back taxes going back ten years, to 1981, 82 and 83. (What will they take for the years 84-91?) Credible legal experts have stated that if the IRS is successful, Executive Life will be totally wiped out, leaving 200,000 investors without the return of a single penny of their investment. We must again mail letters and make phone calls quickly and urgently to our Congressmen and Senators -- above all, send a letter to President Bush. Once again, be sure to mail a copy of these letters to our P.O. Box to guarantee that it will reach its destination

On the accompanying sheets, we've provided some sample letters along with important addresses and phone numbers you'll need to write and phone your State Senators and US Congressmen. If you know other investors who would like to be on our mailing list, let them know about us. It's to their as well as our vital interest -- the greater our numbers, the better our chances in Washington.

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Here are a few sample letters to get your thoughts flowing. What's important is to convey your sense of outrage, and show your determination to not sit still while your hard-earned assets are taken away. Follow your instincts -- but make sure you write!

Dear State Representative ________

I'm writing to raise my voice to request your help in protecting my assets in Executive Life Insurance. My desperately needed money has been frozen by the government, and I stand a good chance of never seeing any of it ever again. My faith in our supposedly "by and for the people" government is reeling from this severe blow.

I'm requesting that you please do everything in your power to prevent the classification of Executive Life as "impaired" as of January 1st, 1991. This would be the end of any hope of getting a return of my investment. My plight, and that of thousands of others like me, requires your full attention and the use of all of the influence you can bring to bear on this matter immediately.

Urgently yours,

Dear Federal Elected Official,

I and 400,000 like me need and demand your help. I placed my hard-earned money into Executive Life Insurance, which has been seized by the State of California. Now on top of everything else, the IRS is demanding back taxes from Executive Life for violations of ten years ago. If they succeed in squeezing that money out of Executive Life, it will destroy the company -- and I will never see a dime of all the money I put into it.

This is a travesty, and I demand you do something about it!

The Federal Government is supposed to serve the public, not to steal from it. I have always paid the taxes due to the IRS, and will continue to do so -- but I refuse to be penalized for the actions of the thieves who are taking advantage of a tragic situation. You took an oath to serve your constituency, and if ever there was a time to redeem that oath it is now. Use your influence to stop the IRS from this unlawful action, or I will do what I can to reduce you to the constituent status from which you came.

Below are ten names of fellow constituents who I am sending this letter to. We will be watching your performance.

Sincerely,

Dear President Bush,

I am a tax-paying citizen, and I pay my share. But if the IRS has its way, I will lose my shirt!

The IRS is trying to seize $643 million in back taxes from Executive Life Insurance -- the thieving company to whom I entrusted my hard-earned savings in good faith, only to watch them collapse before my eyes. If the IRS has its way, the company will be gutted -- and 400,000 of investors like myself will lose all we've put away for our retirement.

This doesn't make sense! The IRS will put us all on welfare, and we'll cost the government billions of dollars! What's more, if the IRS would just leave things be, they stand to collect millions of dollars from people like me who will have to pay taxes on our annuities. It doesn't make business sense, it doesn't make moral sense. It's outrageous, and you have to stop it!

As an elected official, you have a responsibility to your public. CALL OFF THE IRS, and let us pay taxes in peace!

Sincerely,

Donn Sigerson was quoted as follows:

"Am I angry? Of course, I am angry," said Donn Sigerson, a 77-year-old policyholder, who had been trying to withdraw his funds from Executive Life when the State Insurance Commissioner sought a court order Thursday to put the company in conservatorship.

I came in (to surrender a policy) before the regulators took over, and now they are going to hold up my payment. I don't think anything the Insurance Commissioner has said would indicate to me that my money is safe."

Sigerson is so irritated about his inability to get factual information from regulators that he's trying to form a policyholder group that would talk to state officials en masse.

"I think we (policyholders) need to have a single voice, so that the commissioner knows how we feel," Sigerson said. "Divided we have nothing. As an organization, I think we would at least be able to get information more easily."

The response from investors of Executive Life was enormous in letters and phone calls to this announcement. It continued day to day.

On May 2nd we put out our first newsletter. We wrote prototype sample letters to the President, Congressmen and State officials to give them something to get their ideas for their own letters. We also enclosed names and addresses of every elected state officials, Congressmen and President Bush's.

We have had this American dream that if we worked hard, were thrifty and put our money in pensions, insurance and retirement plans we could then enjoy the security if not comfort in our old age—this is now, it turned out to be "pie in the sky".

A new definition has come to have broad coverage in the last few years- some slick gimmick to help us kid ourselves. That term is SENIORS. That we may be, but in reality are just very old and very tired.

It takes CASH money to take care of yourself and not be subjected to the ultimate indignity of government hand-outs, never enough or never on time.

Old age is being alone and depressed with yourself all the time. You are living on less, below a subsistence level. You do not know whether you will see another daylight-it is knowing no one really cares what happens to you.

There are too many Americans in this situation. We do not belong in this group. We made and saved sufficient funds to live to the end of our lives in security if not comfort.

Now our great democracy has stolen this from us thru laxity, ignorance or not caring. We are MAD and ANGRY. We want to make it hurt those who have betrayed us. That is what anger is all about.

We are proposing you might say going so far as demanding that every elected or appointed office hold open house when they are home. They must understand these misdeeds. They, in lard part are responsible.

Only this way we can correct the affliction that haunts every American now. There is little hope on the return of the money. We had no choice but to believe our government could guarantee we would receive our money.

YOU OWE US. You lost our old age security. Let's see a new breed of public servants that look after their own.

YOU OWE US! It is our belief and our hope you will take care of your invoice. It's in ARREARS.

Thank you.

Senator BRYAN. Mr. Sigerson, thank you very much. If we can just get you to remain at the table there, after the other two gentlemen offer their testimony, we will have some questions. That is certainly a very emotional and moving story, and I am sure you speak, as you say, for many thousands of others.

We will have a chance to explore that a little bit.

Mr. Sigman, we would like to welcome you to the hearing, and perhaps you can tell us of the saga of Pacific Lumber.

STATEMENT OF ALFRED SIGMAN, SIGMAN AND LEWIS, OAKLAND, CA

Mr. SIGMAN. Thank you, Mr. Chairman.

My name is Alfred Sigman. I am a partner in the Oakland, CA, law firm of Sigman and Lewis. For the past 15 years, we have specialized in litigation and consulting work regarding the Employee Retirement Income Security Act or ERISA, for short.

From January 1978 to December 1985, I served by appointment of the Secretary of Labor as a member of the ERISA Advisory Council, representing the general public. And during the period 1984 to 1985, I served as a representative of the Secretary of Labor on the National Pension Forum, a bipartisan interagency commission established to review the then 10-year history of ERISA.

For the past several years, my firm and I have represented employees and former employees of the Pacific Lumber Co. In that suit, we challenged their employer's decision to replace their pensions with annuities from Executive Life Insurance Co. which, among other things, we believed to be a bad risk.

Thus, the recent collapse of Executive Life, which may have a potentially devastating effect on my clients as well as on tens of thousands of other workers, retired workers, and families across the country, came as no surprise to us. On behalf of myself, my firm, and the Pacific Lumber Co. retirees and workers whom we represent, I welcome this opportunity to express my views on the seizure of Executive Life and on the broader implications of that seizure as far as my clients and other annuitants are concerned.

As has been widely reported, the recent imposition of a conservatorship on Executive Life by the California insurance commissioner is the largest such insurance company takeover in U.S. history. Over one-half of Executive Life's purported $10 billion in assets consists of junk bonds, most of which are of dubious value.

Among those most drastically affected by the inability of Executive Life to meet its obligations are employees and former employees of companies which terminated their well-funded pension plans and replaced them with Executive Life annuities. An estimated 15 to 18 companies did this. The plight of my clients and the approximately 2,500 participants and beneficiaries of the Pacific Lumber Retirement Plan is only illustrative.

The Pacific Lumber Co. is headquartered in the small company town of Scotia in northern California, which is California's redwood country. For many years, Pacific Lumber sponsored a pension plan which paid monthly benefits to its retired workers and their beneficiaries. By design, the plan was funded in excess of ERISA's minimum requirements, so as to provide for a safety cushion and allow for the possibility of cost-of-living increases to retirees. In addition, since the Plan was a defined benefit plan, benefits were insured by the Federal Pension Benefit Guaranty Corporation, an entity established in 1975 by ERISA.

In 1985, Pacific Lumber was taken over on a leveraged buyout by corporate raider Charles Hurwitz and his Maxxam companies. The takeover was largely financed through a Drexel Burnham junk bond offering. The largest single purchaser of these junk bonds was First Executive Corp. One of the reasons why Pacific Lumber was a takeover target was the so-called surplus in the retirement plan. Under current law, an employer may terminate a pension plan, purchase a group annuity contract to pay the pension obligations, and recoup the remaining so-called surplus pension funds for its own uses.

In 1986, shortly after the takeover, Maxxam terminated the Pacific Lumber plan and captured, or recaptured, approximately $55 million in so-called surplus plan assets, which it then used to pay off part of the takeover debt. Based on the recommendation of an outside consultant, illustrative bids for a annuity contracts were solicited from a number of insurance companies. Executive Life was not on the list of recommended companies. Maxxam's top officers ordered Executive Life's inclusion in the bidding process and Executive Life was awarded the contract after it purportedly submitted the lowest bid.

Maxxam's top officers were specifically informed by Pacific Lumber's then treasurer, Vincent Garner, that Executive Life was able to offer low prices because it concentrated its investments in high-yield, high-risk junk bonds to a far greater degree than other insurance companies. Mr. Garner also pointed out that Executive Life had improved its statutory reserve position through questionable reinsurance arrangements, which were under scrutiny by several States and that the outside consultant had ranked Executive Life below other companies which had submitted bids. Mr. Garner also advised Maxxam that Executive Life's involvement in the financing of the Pacific Lumber takeover, and its close relationship with Drexel Burnham, raised questions of prohibited transactions.

Nevertheless, despite their knowledge of the serious risks associated with purchasing annuities from Executive Life, Maxxam's top officers insisted on that purchase. Executive Life received approximately $38 million in plan assets and assumed the obligation to pay the approximately 2,500 current and future Pacific Lumber retirees the same monthly benefits which they would otherwise have received from the plan. Many Pacific Lumber retirees and employees were concerned about the long-term future of Executive Life and the future of their pensions. As I will discuss in more detail, we brought suit on their behalf in September of 1989.

Other Pacific Lumber workers and retirees simply could not believe that their formerly paternalistic employer would place their pensions at risk. This belief was fostered by Pacific Lumber and Maxxam, even as more and more articles about Executive Life's finances began appearing in the press during the past two or three years. Thus, when some of my clients, together with the nonprofit Pacific Lumber Rescue Fund, called an informational meeting to discuss their concerns about Executive Life in 1989, Pacific Lumber's president distributed a letter to employees in which he stated that, "the unfair allegation that Executive Life may go bankrupt is unfounded." He accused my clients of "scare tactics." Indeed, as late as last October, a Maxxam spokesperson was quoted in a local newspaper as saying that the annuities were, "as good as gold." Predictably and tragically, this looks more and more as though it were fool's gold rather than the gold that the Maxxam spokesman had referred to.

When California Insurance Commissioner Garamendi placed Executive Life in conservatorship, he immediately obtained a court order forbidding payments to all annuitants and policyholders. The 2,600 Pacific Lumber annuitants—as well as an estimated 75,000 more from the 15 to 18 other companies, which also had replaced their pension plans with Executive Life annuities—faced the loss of their principal source of retirement income.

Upon learning of the failure of Executive Life, Hollis Rollins, an 85-year-old Pacific Lumber retiree and client, who worked all of his adult life for the company, suffered seizures and had to be hospitalized. William Hunsaker, 72, had worked 47 continuous years for Pacific Lumber. His wife is confined to a convalescent hospital at a cost of $2,400 per month. They depend on their Pacific Lumber/Executive Life annuity to meet a portion of this and other living expenses. They simply cannot afford to lose any of it. None of the retired loggers and their spouses who are our clients can afford the loss of even a few hundred dollars a month in pension benefits. Some, who spent their entire working lives in the company-owned of Scotia and moved away only upon retirement, may not even own property against which they can borrow to meet current expenses.

Subsequently, the California insurance commissioner has obtained a modification of the court order providing that on an interim basis, 70 percent of each individual's monthly retirement benefit will be paid. However, this is only a temporary measure and it could cease at any time. In fact, within days after this modification, the Internal Revenue Service filed a claim for over $600 million against Executive Life for alleged unpaid taxes from 1980 through 1982, and it is expected that it will assert even larger claims for Executive Life's later and more lucrative years.

IRS claims take priority over all other claims. As the California insurance commissioner has stated, such developments or a determination to liquidate Executive Life could result in a complete cessation or substantial reduction of all payments. In addition, faced with public pressure including a demonstration of over 100 Pacific Lumber's retirees and workers, Maxxam agreed to make up the shortfall in retiree pensions for May and June.

We learned yesterday that they have agreed to a more open-ended commitment, but our clients still cannot be certain—they certainly do not have the guarantee that they expected when they reached their retirement age.

Despite the temporary and short-term commitments of the insurance commissioner and Maxxam, the future is highly uncertain and filled with tragic potential. My own person opinion, based upon reviewing documents and financial statements, is that the likely long-term future for Executive Life is liquidation. In the case of the last substantial life insurance company failure in California, this process took 6 years. Given the size of Executive Life, it could be many more years before policyholders and annuitants have any solid and reliable information about the obligations owed to them, and even then they may receive only pennies on the dollar.

Absent success in the lawsuit, the Pacific Lumber employees and former employees will have to look to the possibility of recovery from Federal and State guaranty funds. However, the ERISA-created Pension Benefit Guaranty Corporation, or PBGC for short, has consistently taken the position that once annuities have been purchased in connection with a plan termination, it no longer insures the pension plan benefits. The PBGC does not collect premiums for such insurance. Although ERISA does not explicitly state that there is or is not such coverage, given the PBGC's own shaky finances, and its consistent interpretation of the statute as excluding such coverage, it is highly unlikely that any court would find that there is PBGC coverage.

In the absence of PBGC coverage, retirees must look to their State guaranty funds. While 47 States have such funds, New Jersey, Louisiana, Colorado, and the District of Columbia do not. They are subject to a variety of conditions, exclusions, and dollar limitations. Thus, the amount of coverage nationwide is limited, as are the types of contracts covered and the funds' abilities to assess insurance carriers.

The recently enacted California Life Insurance Guaranty Fund does not guarantee the obligations of companies that were insolvent or financially impaired with the fund became effective this past January 1, 1991. Thus, if Executive Life were found to have been financially impaired, no guaranty funds would be available from the State guaranty fund. Although the insurance commissioner has stated that he does not believe First Executive was impaired as of January 1, this could be subject to revision or serious legal challenge, given that Executive Life's decline probably did not occur all in the past four months.

Even assuming the applicability of the California fund, there are various dollar limitations contained in the California law. Although Pacific Lumber retirees will not have to worry about the $100,000 cash value limitation on an individual contract, they might be effected by an overall $5 million limitation applicable to certain group contracts. If this were to be the case, and given that the annuities cost over $37 million, our clients will only collect a small fraction of their benefits from the guaranty fund.

In terms of what I feel that the Congress could do to remedy this situation, at least in regard to the purchase of annuities, I could recommend five possible courses of action. The first would be to simply prohibit the practice of plan termination and reversions. Now in recent years, Congress has deterred employers from terminating defined benefit plans to recapture assets by imposing excise taxes on resulting reversions. However, an outright prohibition of such reversions would certainly further limit the instances in which annuities replace pensions.

In addition, we would propose the use of an independent fiduciary. An amendment of ERISA to provide that in any situation where there will be a reversion of assets to the employer, an independent fiduciary should be appointed to make the choice of the insurance carrier. That would assure that the employer, who is in the difficult position of having to wear at least two hats, that of employer and that of plan sponsor and fiduciary, would not have to make that decision, but rather it would be delegated to a truly independent individual with that authority and power.

We also would recommend that the PBGC could be given the power to determine which insurance companies are eligible to act as providers of annuities. For administrative convenience and to avoid excessive bureaucracy, the PBGC could require that the carriers be licensed in the State of New York, or in other States with relatively strict requirements for doing business.

We would also suggest that PBGC protections be extended to cover annuities purchased by terminated plans. A lump sum premium, for example, could be assessed by the PBGC at the time of termination.

And, finally, we would suggest that Congress strengthen private enforcement of ERISA by amending the act to provide for mandatory disclosure of details of the selection process to plan participants, a mandatory award of attorneys' fees to prevailing plaintiffs in ERISA actions, and a mandatory award of expert witness fees to prevailing plaintiffs in ERISA actions. These cases are extremely dependent upon expert witness testimony, which can be very difficult for retired individuals living on fixed incomes to afford.

Thank you.

[The prepared statement of Mr. Sigman follows:]

Prepared Statement of Alfred H. Sigman

I am a partner in the Oakland, California, law firm of Sigman & Lewis. For the past fifteen years, my partner, Jeffrey Lewis, and I have specialized in litigation and consulting work regarding the Employee Retirement Income Security Act (ERISA). From January, 1978, to December, 1985, I served by appointment of the Secretary of Labor as a member of the ERISA Advisory Council, representing the general public. During 1984–85, I served as one of the Secretary of Labor's representatives on the National Pension Forum, a bipartisan inter-agency commission established to review the then ten-year history of ERISA. I have also taught law school courses in ERISA, and I have lectured and spoken widely in the field.

For the past several years, my firm has represented employees and former employees of Pacific Lumber Company. In that suit, we challenged their employer's decision to replace their pensions with annuities from Executive Life Insurance Company, which, among other things, we believed to be a bad risk. Thus, the recent collapse of Executive Life, which may have a potentially devastating effect on my clients, as well as tens of thousands of other workers, retired workers, and families across the country, comes as no surprise to us. On behalf of myself, my law firm, and the Pacific Lumber Company retirees and workers whom our firm represents, I appreciate the opportunity to express my views on the seizure of Executive Life and the broader implications of that seizure.

I. THE EXECUTIVE LIFE SEIZURE AND ITS IMPACT ON EMPLOYEE RETIREMENT INCOME SECURITY

As has been widely reported, the recent imposition of a conservatorship on Executive Life by the California Insurance Commissioner is the largest such insurance company takeover in U.S. history. Over one-half of Executive Life's purported 10 billion dollars in assets consists of "junk bonds," most of which are of dubious value. Among those most drastically affected by the inability of Executive Life to meet its obligations are employees and former employees of companies which terminated their well-funded pension plans and replaced them with Executive Life annuities. An estimated 15 to 18 companies did this. The plight of my clients and the approximately 2,500 participants in and beneficiaries of the Pacific Lumber Retirement Plan is illustrative.

A. THE HISTORY OF THE PACIFIC LUMBER PENSION SITUATION

Pacific Lumber Company is headquartered in the small company town of Scotia, California, in California's redwood country. For many years, Pacific Lumber sponsored a pension plan which paid monthly benefits to its retired workers and their beneficiaries. By design, the plan was funded in excess of ERISA's minimum requirements, so as to provide for a safety cushion and allow for the possibility of cost-of-living increases to retirees. In addition, since the Plan was a defined benefit plan, benefits were insured by the Pension Benefit Guaranty Corporation.

In 1985, Pacific Lumber was taken over in a leveraged buyout by corporate raider Charles Hurwitz and his Maxxam companies. The takeover was largely financed through a Drexel Burnham junk bond offering. The largest single purchaser of these junk bonds was First Executive Corporation. One of the reasons why Pacific Lumber was a takeover target was the so-called "surplus" in the retirement plan. Under current law, an employer may terminate a pension plan, purchase a group annuity contract (or set aside sufficient funds) to pay the pension obligations, and recoup the remaining "surplus" pension funds for its own uses.

In 1986, shortly after the takeover, Maxxam terminated the Pacific Lumber plan and captured approximately $55 million dollars in "surplus" plan assets, which it then used to pay off part of the takeover debt. Based on the recommendation of an outside consultant, illustrative bids for annuity contracts were solicited from a number of insurance companies. Executive Life was not on the list of recommended companies. Maxxam's top officers ordered Executive Life's inclusion in the bidding process. Executive Life submitted the lowest bid.

Maxxam's top officers were specifically informed by Pacific Lumber's then-Treasurer, Vincent Garner, that Executive Life was able to offer low prices because it concentrated its investments in "high yield/high risk" junk bonds to a far greater degree than other insurance companies. Garner also pointed out that Executive Life had improved its statutory reserve position through questionable reinsurance arrangements which were under scrutiny by several states, and that the outside consultant had ranked Executive Life below other companies which had submitted bids. Garner also noted Executive Life's involvement in the financing of the Pacific Lumber takeover and its close relationship with Drexel Burnham.

Despite their knowledge of the serious risk associated with purchasing annuities from Executive Life, Maxxam's top officers insisted on that purchase. Executive Life received approximately $38 million dollars in plan assets and assumed the obligation to pay the 2,500 current and future Pacific Lumber retirees the same monthly benefits which they would otherwise have received directly from the retirement plan. Many Pacific Lumber retirees and employees were concerned about the long-term future of Executive Life and the future of their pensions. As I will discuss in more detail below, we brought suit on their behalf in September, 1989.

Other Pacific Lumber workers and retirees could not believe that their formerly paternalistic employer would place their pensions at risk. This belief was fostered by Pacific Lumber and Maxxam, even as more and more articles about Executive Life's finances began appearing in the press during the past two or three years. Thus, when some of my clients, together with the non-profit P.L. Rescue Fund, called an informational meeting to discuss concerns about Executive Life in 1989, Pacific Lumber President John Campbell distributed a letter to employees in which he stated that "the unfair allegation that Executive Life may go bankrupt is unfounded." He accused my clients of "scare tactics." As late as this past October, a Maxxam spokesperson told a reporter that the annuities were "as good as gold." Predictably and tragically, this looks more and more as though it was "fool's gold."

B. THE IMPACT OF EXECUTIVE LIFE'S FAILURE

When California Insurance Commissioner Garamendi placed Executive Life in conservatorship, he immediately obtained a court order forbidding payments to all annuitants and policyholders. The 2,600 Pacific Lumber annuitants (as well as an estimated 75,000 more from the 15 to 18 other companies which also had replaced their pension plans with Executive Life annuities) faced the loss of their principal source of retirement income.

Upon learning of the failure of Executive Life, Hollis Rollins, an 85-year old Pacific Lumber retiree who worked all of his adult life for Pacific Lumber, suffered seizures and had to be hospitalized. William Hunsaker, 72, worked 47 years for Pacific Lumber. His wife is confined to a convalescent hospital at a cost of $2,400 per month. He depends on his Pacific Lumber- Executive Life annuity to meet a portion of this and his other living expenses. He can't afford to lose any of it. None of the retired loggers and their spouses who are our clients can afford the loss of even a few hundred dollars a month in pension benefits. Some, who spent their working lives in the company-owned town of Scotia and moved away only upon retirement, may not even own property against which they can borrow to meet expenses.

Subsequently, the California Insurance Commissioner has obtained a modification of the court order providing that on an interim basis, 70% of each individual's monthly retirement benefit will be paid. (The order provides that any such payments will result in an assignment to the conservator of a like amount of any future recovery by the annuitant from the state guaranty fund.) However, this is only a temporary measure and it could cease at any time. In fact, within days after this modification, the Internal Revenue Service filed a claim for over $600 million against Executive Life for unpaid taxes from 1980 through 1982, and it is expected that it will assert even larger claims for Executive Life's later and more lucrative years. IRS claims take priority over all other claims. As the California Insurance Commissioner has stated, such developments or a determination to liquidate Executive Life could result in the complete cessation or substantial reduction of all payments. In addition, faced with public pressure, including a demonstration of 100 of Pacific Lumber's retirees and workers, Maxxam agreed to make up the shortfall in retiree pensions for May and June. However, it made no commltent beyond that time.

Despite the temporary and short-term commitments of the Insurance Commissioner and Maxxam, the future is highly uncertain and filled with tragic potential.

C. FEDERAL AND STATE GUARANTY FUNDS

The likely long-term future for Executive Life is liquidation. In the case of the last substantial life insurance company failure in California, this process took six years. Given the size of Executive Life, it could be many years before policyholders and annuitants have any solid and reliable information about the obligations owed to them, and even then they may receive only pennies on the dollar.

Absent success in our lawsuit, the Pacific Lumber employees and former employees will have to look to the possibility of recovery from federal and state guaranty funds. However, the ERISA-created Pension Benefit Guaranty Corporation (PBGC) has consistently taken the position that once annuities have been purchased in connection with a plan termination, it no longer insures the pension plan benefits. The PBGC does not collect premiums for such insurance. Although ERISA does not explicitly state that there is or is not such coverage, given the PBGC's own shaky finances and its consistent interpretation of the statute as excluding such coverage, it is highly unlikely that any court would find that there is PBGC coverage.

In the absence of PBGC coverage, retirees must look to their state guaranty funds. While 47 states have such funds (New Jersey, Louisiana, Colorado and the District of Columbia do not), they are subject to a variety of conditions, exclusions, and dollar limitations. Thus, the amount of coverage nationwide is limited, as are the types of contracts covered and the funds' abilities to assess insurance carriers. (The American Council of Life Insurance prepared a summary in August, 1990, of the different provisions of the 47 state guaranty funds.)

The recently-enacted California Life Insurance Guaranty Fund does not guarantee the obligations of companies that were insolvent or financially impaired when the fund became effective on January 1, 1991. Thus, if Executive Life were found to have been financially impaired, no guaranty funds would be available. Although the Insurance Commissioner has stated that he does not believe First Executive was impaired as of January 1, this could be subject to revision or serious legal challenge given that Executive Life's decline probably did not suddenly occur in the last four months.

Even assuming applicability of the California fund (i.e., no impairment), there are various dollar limitations contained in the California law. Although Pacific Lumber retirees will not have to worry about the $100,000 cash value limitation on an individual contract, they might be affected by an overall $5 million limitation applicable to certain group contracts. If this were to be the case, and given that the annuities cost $37 million (even at Executive Life's bargain price), our clients will only collect a small fraction of their benefits from the guaranty fund.

Moreover, state guaranty funds overall are limited in the assessments they can levy on insurance companies, generally 2% of the premiums paid in any line of business in a state. The Wall Street Journal has reported:

"The life industry's assessment capacity for all states combined for insolvency needs in any one year is about $1 billion. But that amount could be exceeded in a single major insolvency such as First Executive's. In any case, it would impose a substantial strain on the industry." (Wall Street Journal, April 8, 1991.)

II. THE PACIFIC LUMBER LAWSUIT AND THE GOVERNING LAW

ERISA permits an employer to terminate its pension plan and recapture so-called surplus assets so long as the language of the governing plan document allows such a reversion and so long as annuities are purchased (or sufficient assets set aside) to meet benefit commitments. Courts have uniformly rejected challenges to such reversions, holding that decisions to terminate a plan and to amend a plan to allow for reversions are corporate, rather than fiduciary, decisions.

However, despite an absence of case law, there does not seem to be any dispute that select ion of an insurance company to provide annuities is subject to ERISA's fiduciary standards. These standards include both the duty to act in the sole interest of the plan participants and beneficiaries and the duty to make a prudent selection.

Our lawsuit, which is pending in United States District Court, alleges that in selecting Executive Life, Pacific Lumber, Maxxam, and their top officers breached both of those fiduciary duties. First, it seems clear that the selection of Executive Life, despite the knowledge of its heavy investment in high-risk junk bonds and its questionable reinsurance arrangements, was clearly imprudent. Second, we allege that in choosing Executive Life, Maxxam and the other defendants violated the duty to act for the sole benefit of the plan participants. Maxxam's choice of Executive Life was either motivated by its desire to reward Executive Life for its role in financing the takeover of Pacific Lumber and/or by its desire to maximize the recapture of plan assets to the exclusion of all other factors (given the fact that Executive Life was the lowest bidder).

We also sued Executive Life, and although we successfully resisted a motion to dismiss them from the action, there are concerns as to our claims against them under current Ninth Circuit doctrine. Executive Life was not a fiduciary at the time of the purchase of the annuity contract. In every other federal court of appeals circuit, non-fiduciaries may be sued under ERISA for participating in a fiduciary's breach of duty. However, this is not the case in the Ninth Circuit.

Our lawsuit sought to rescind the annuity purchase, to replace Executive Life with a top-flight insurance company, and to require Maxxam to pay any additional amount necessary to buy annuities from the successor company. At the time the conservatorship was imposed, we were engaged in settlement negotiations with Maxxam and Executive Life to that effect. We are hoping that the Insurance Commissioner will continue those negotiations. But even if those negotiations fail, we will seek through the lawsuit to force Maxxam to pay for new annuities from a solid, first-rate insurance company. We believe that this remains our clients' best hope, and it may be the best hope of at least some others around the country. However, we are aware of only one other lawsuit similar to ours. I believe that the lack of other actions may be attributable, in part, to significant disincentives in the law, including the uncertainty of recovering attorneys' fees and the high cost of such litigation.

III. THE ABSENCE OF FEDERAL AGENCY ACTION

The Department of Labor, which has the power to bring suit for breach of fiduciary duty, has not done so, despite the fact that it has had an open investigation of the Pacific Lumber case for several years. In fact, the Department has not brought any lawsuits challenging the selection of Executive Life or any other carrier as an annuity provider. The Department's policy has been to bring suit in situations where important legal principles can be established and/or where legal action can benefit large numbers of participants. Given the virtual absence of private litigation efforts, it is surprising that the policy-makers in the Department have not authorized their highly skilled attorneys to challenge the selection of Executive Life.

In addition, until the last year, the Department of Labor had not even publicized its position that the selection of an annuity provider was subject to those duties.

Finally, as reported by the American Society of Pension Actuaries, the Pension Benefit Guaranty Corporation, which is informed of all annuity purchases related to plan terminations, has no written or firm standards for referring other cases to the Department of Labor.

IV. RECOMMENDATIONS FOR CONGRESSIONAL AND OTHER ACTION

Future Executive Life situations could be avoided by adoption of some or all of the following measures:

1. Prohibit Reversions. In recent years, Congress has deterred employers from terminating defined benefit plans to recapture assets by imposing excise taxes on resulting reversions. However, an outright prohibition of such reversions would certainly further limit the instances in which annuities replace pensions.
2. Independent Fiduciary. Amendment of ERISA to provide that in any situations where there will be a reversion of assets to the employer, an independent fiduciary must be appointed to make the choice of insurance carrier.
3. Regulation of Insurance Companies. The PBGC could be given the power to determine which insurance companies are eligible to act as providers of annuities. For administrative convenience and to avoid excessive bureaucracy, PBGC could require that the carriers be licensed in New York and/or other states with the strictest requirements for doing business.
4. Extension of PBGC Coverage. PBGC protections could be extended to cover annuities purchased by terminated plans. A lump sum premium could be assessed at the time of termination.
5. Strengthen Private Enforcement. The ability of a private party to challenge annuity carrier selections could be strengthened by a combination of the following: (a) mandatory disclosure of details of the selection process to plan participants, (b) mandatory award of attorneys' fees to prevailing plaintiffs in ERISA actions, and (c) mandatory award of expert witness fees to prevailing plaintiffs in ERISA actions (which are often dependent on expensive expert witness testimony).

Senator **BRYAN**. Thank you very much, Mr. Sigman.

Mr. Sarfaty, am I pronouncing your name correctly, sir?

Mr. **SARFATY**. No. Sarfaty.

Senator **BRYAN**. Mr. Sarfaty. Why do not you scoot around just a little bit. I would not want you to appear to be on periphery of this issue, we want you right up there at the table. Great.

If you will just pull that microphone a little bit closer to you, we will be delighted to hear from you now, sir.

STATEMENT OF EDEN D. SARFATY, PRESIDENT, NOLHGA, HERNDON, VA

Mr. **SARFATY**. Thank you, Mr. Chairman and members of the committee.

My name is Eden Sarfaty. I am president of the National Organization of Life and Health Insurance Guaranty Associations, NOLHGA.

NOLHGA was formed in 1983 as the last substantial life insurer insolvency, Baldwin-United, began to unfold. NOLHGA is the national arm of the State life and health insurance guaranty association system. We provide informational, educational, analytical, coordinative, and increasingly, operational assistance to our member State associations. NOLHGA's role is recognized by the National Association of Insurance Commissioners as an integral part of that State system. Our members comprise all but one of the existing State life and health insurance guaranty associations.

The national organization and its members are working now with California Insurance Commissioner John Garamendi and other State insurance regulators to review the condition of Executive Life Insurance Co. and its affiliates. Together, within the framework of the State insurance guaranty laws, we are developing a unitary plan to protect policyholders' insurance needs and avoid unnecessary losses.

In accordance with our established procedures, a taskforce of member associations has been formed to address a variety of developments, both financial and legal. It is still too early to say for sure how our participation will be structured or how large our contributions will be. Initial indications are, however, that most if not all individual policyholders' insurance coverage will be honored and that any losses to individuals are likely to be small. Responsible parties will be carefully examined.

Let me repeat that. Responsible parties will be carefully examined, and we would like very much to cooperate with the earlier witnesses and others similarly situated in that effort.

Despite some differences among States, for the vast majority of individuals who purchase insurance, guaranty association coverage is remarkably uniform. Generally speaking, $100,000 in cash, comparable to the Federal guaranty levels, and $300,000 in death benefits, or in aggregate benefits of all types per individual.

In contrast, there is, as an earlier witness indicated, significant variations in the treatment of unallocated funding obligations, including GIC's which are commonly purchased as pension plan assets on professional, sophisticated advice by pension plan trustees.

If needed, NOLHGA's member guaranty associations can provide billions of dollars within the limits of their State guaranty laws, but every penny that we spend to help some policyholders eventually comes out of the pockets of other people in higher premiums or in reduced interest rates, dividends, or tax revenues. We are going to continue to be very careful how we spend that money. The system as a whole is designed to refuse to make offers that you cannot afford.

There really is not enough money in the world to guarantee all of the obligations of financial fiduciaries. I am sure we all wish it were different.

The State guaranty laws are set up as a safety net for policyholders, not to bail out a few badly managed companies. The system has checks and balances built into it, among State regulators, receivers, courts, and guaranty associations. We consult to assure fairness and coordinate for efficiency.

We believe that State regulators and guaranty associations record of protection is really quite good, and the systems are constantly adapting to meet new challenges. Few insurers, fortunately, were infected with the fever of speculation which swept Wall Street and is still killing so many banks and savings and loans.

We believe that the guaranty system has provided and, with its very significantly increased financial capacity over the past few years, will continue to provide real policyholder protection within reasonable limits for life and health insurance and annuities.

Moreover, we strongly support the measures that have been developed by the National Association of Insurance Commissioners in recent years to improve solvency surveillance. Implementation of the valuation actuary concept and development of risk-based capital requirements are two of the most promising, recent initiatives. When fully implemented, we expect they will provide significant additional improvement in detection of insurer impairments and prevention of insolvencies. The real answer, of course, resides not on guaranteeing after the fact, but on preventing before the fact.

As I indicated, there is not enough money under any system possibly available simply to guarantee everything to everybody. The Federal Government has found to its and to the taxpayers' chagrin that that is not possible to do by way of Federal guarantees, whether by way of social security programs, Federal deposit insurance programs, savings and loan insurance programs, housing insurance programs, or pension insurance programs. All of them have suffered very significant, in fact astronomical, losses.

The insurance industry and its guaranty system, in contrast, with a few and unfortunately prominent exceptions on occasion, are very financially sound, and our system is healthy.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Sarfaty follows:]

PREPARED STATEMENT OF EDEN SARFATY

Good morning Mr. Chairman and members of the Committee. My name is Eden Sarfaty. I am president of the National Organization of Life and Health Insurance Guaranty Associations, NOLHGA.

NOLHGA was formed in 1983 as the last substantial life insurer insolvency, Baldwin-United, began to unfold. NOLHGA is the national arm of the state life and health insurance guaranty association system. It provides informational, educational, analytical, coordinative and operational assistance to its members. NOLHGA's role is recognized by the National Association of Insurance Commissioners (NAIC) in its Model Life and Health Insurance Guaranty Association Act, the basis of virtually all of the state guaranty laws, as an integral part of the guaranty system. Our members comprise all but one of the life and health insurance guaranty associations which have been established as of this date.

PURPOSE

Guaranty associations are created by state law "to protect policyowners, insureds, beneficiaries, annuitants, payees and assignees against losses (both in terms of paying claims and continuing coverage) which might otherwise occur due to an impairment or insolvency of an insurer." (NAIC Model Life and Health Insurance Guaranty Act, as amended.)

STRUCTURE OF CURRENT SYSTEM

Composition of Members: The guaranty associations are non-profit legal entities whose members comprise all insurance companies licensed to write life and health insurance or annuities in the state. Each association is governed by a board of directors approved by the state's insurance commissioner.

Locations: By July 1991, Life and health insurance guaranty associations will be established in 48 states and Puerto Rico. (Colorado enacted such legislation this month, to become effective July, 1991.)

The three jurisdictions currently without a life and health insurance guaranty association act are: District of Columbia, Louisiana and New Jersey.

POLICY GUARANTEES

Life and health insurance guaranty associations cover most life insurance policies, health insurance policies and annuities, and the vast majority of the insurance buying public.

Exclusions: In general, guaranty acts exclude from coverage policies issued by entities that are not regulated under the standards applicable to legal reserve carriers. Insurance exchanges, assessment companies, fraternals, HMOs and, in many cases, the Blues, are commonly excluded.

The guaranty laws also commonly exclude from coverage policies, or portions of policies, under which the risk is borne by the policyholder or which are not guaranteed by the insurer. Variable accounts in some life policies or annuity contracts are examples.

Despite some differences among states, for the vast majority of individuals who purchase insurance, guaranty association coverage is remarkably uniform. In contrast, significant variation does exist in the treatment of UFO (unallocated funding obligations, including GICs), which are commonly purchased as pension plan assets on professional, sophisticated advice by pension plan trustees. Twenty states have not yet explicitly addressed whether or how such products are covered; two states cover them fully; fourteen limit coverage; and thirteen, including California, exclude them.

Limits of Protection: Residency Limits: Most guaranty associations limit their protection to policyholders who are residents of their own state. (It does not matter where the policyowner's beneficiaries live.) The trend toward adopting such a residents-only provision follows a major amendment to NAIC's model guaranty act adopted in 1985. Virginia and West Virginia, in fact, very recently amended their life-health guaranty laws to cover their own residents.

Furthermore, if the insolvent insurer's domiciliary state follows the NAIC model, coverage would be extended by the domiciliary state to residents of another state if that state also has a similar guaranty act and the impaired company was not licensed there and the policyholder is not eligible for coverage there. An example of such a situation would be a New York resident who owns a policy of the Executive Life Insurance Company,which is domiciled (chartered) in California. Since New York has a life-health guaranty association but the company was not licensed to do business there, New York residents would look to the California Life Insurance Guaranty Association for protection, should that be necessary. However, residents of states, such as Louisiana, which do not have a life-health insurance guaranty association would have no guaranty association protection, even though Executive Life was licensed there.

Other states, such as Nevada and South Carolina, still follow an older model act and guaranty benefits of impaired or insolvent insurers domiciled in their own state, no matter where the policyholders live, and, also cover their own residents who are policyholders of licensed companies domiciled in other states.

Dollar Limits: Typically, states protect direct life policies to a limit of $300,000 in death benefits, $100,000 cash or withdrawal value for life insurance, $100,000 in present value of annuity benefits, and $100,000 in health benefits. Often there is a limit of $300,000 for all benefits combined, per policyholder. Unallocated annuity contracts, or, more generally, unallocated funding obligations, when guaranteed, are usually subject to a $5 million limit of protection with respect to any one contractholder, no matter how many contracts are held nor how many persons are employed by the contractholder.

Unallocated Annuity Limits: As indicated above, all state life and health insurance guaranty associations generally cover individual annuities and certificates under group annuities up to $100,000 per individual. However, thirteen states specifically exclude from coverage unallocated annuities or unallocated funding obligations (UFOs). (An unallocated annuity is an annuity contract or group annuity certificate which is not issued to and owned by an individual. Employers often purchase such investment vehicles to fund retirement plans.) "Guaranteed investment contracts"(GICs) are one type of unallocated annuity contract. As you may know, Executive Life Insurance Company, holds over $3 billion in GIGs in force, many of which are unallocated.

California, Hawaii, Idaho, Massachusetts, Kansas, Kentucky, Missouri, Oklahoma, Oregon, South Dakota, Tennessee, Utah and Virginia exclude unallocated funding obligations from coverage. UFOs are presently covered, with certain limits, in fifteen states: Alaska, Arkansas, Connecticut, Georgia, Iowa, Illinois, Indiana, Michigan, Minnesota, Mississippi, North Dakota, New York, Ohio, Texas, and Washington. The other state guaranty laws are silent on this subject.

The types of unallocated annuities not covered under the NAIC Model Act are "financials" (an unallocated annuity contract which is not issued to or in connection with a specific employee, union or association of natural persons benefit plan or a government lottery) and any unallocated annuity contract issued to an employee benefit plan protected under the Federal Pension Benefit Guaranty Corporation.

MEANS BY WHICH POLICIES ARE GUARANTEED

Triggers: Generally, the guaranty associations provide coverage when the company has been declared financially impaired or has been ruled to be insolvent by a court of law. However, there are certain situations preceding such a judicial action when many associations may take a number of measures to cover the impaired insurer's policyholder obligations. However, since the primary purpose of the guaranty associations is to protect policyholders, and not to bail out impaired or insolvent insurers, most associations are reluctant to provide funds before liquidation, unless it is clearly demonstrated that to do so in a particular case will be less costly over time.

Coverage Options: Guaranty associations may provide coverage directly, or through outside administrators or other insurance companies. In many cases, the guaranty association will continue coverage for the full policy period. It may do this directly or it may transfer the policy to another insurer or administrator.

In multi-state insolvencies, most guaranty associations work through NOLHGA which secures, on their behalf, an assumption reinsurance agreement with another insurer or a claims servicing agreement with a third party administrator.

Multi-state Licensed Impaired Insurers: If the impaired or insolvent insurer is licensed in more than one state, as most are, NOLHGA's Disposition Committee members work closely with domestic receivers and affected guaranty associations to protect policyholders and insure early and equitable access of guaranty associations to the insolvent company's assets. On behalf of its participating member guaranty associations, NOLHGA's Disposition Committee expedites reinsurance assumptions, claims processing and audits.

FUNDING AND CAPACITY OF THE CURRENT SYSTEM

Means: In order to cover costs of providing benefits to policyholders, the guaranty association assesses the money it needs from its other insurance company members. The amounts the member companies must pay depends on how much insurance they write of the same type or types (life or health or annuities) for which the association is assessing (collecting). These assessments are performed after an insurer is declared financially impaired or insolvent by a court.

If affected by many insolvencies, or an especially large one, an association may assess over a number of years, if necessary. In addition guaranty associations have a priority position, after the receiver's expenses, to early access to assets of the insolvent insurer's estate.

Nationwide Capacity: The annual financial capacity of the life-health insurance guaranty system is approximately $3.06 billion. This is based on a total premium base of $165.8 billion. An average of $110,155,312 was assessed nationally for life, health and annuity lines in the three year period 1987 through 1989. That is less than 4 percent of total annual assessment capacity. The total amount assessed over last ten years was somewhat over $473 million.

State Limits: Member insurers' assessments may not exceed a certain sum each year. That amount, set by state law, is a percentage of their previous year's, or average of previous three years', premiums written in that state. Assessment limits differ among the states, but range between one and four percent of premiums written. Two percent is the common limit. In most states, insurers may offset a percentage of these assessments through tax reductions.

CONCLUSION

Thank you for this opportunity to explain the guaranty system.

The state guaranty laws are set up as a safety net for policyholders, not to bail out a few badly managed companies. The system has checks and balances built in: among state regulators, receivers, courts and guaranty associations. We consult to assure fairness, coordinate to assure efficiency.

State regulators' and guaranty associations' record of protection is good, and the systems are constantly adapting to meet new challenges. Few insurers were infected with the fever of speculation which swept Wall Street and is still killing so many savings and loans and banks. We believe that the guaranty system has provided and, with its increased financial capacity, will continue to provide real policyholder protection within reasonable limits for life and health insurance and annuities.

Furthermore, we strongly support the measures developed by the National Association of Insurance Commissioners in recent years to improve solvency surveillance. Implementation of the valuation actuary concept and development of risk based capital requirements are two of the most promising recent initiatives. When fully implemented, we expect they will provide significant additional improvement in detection of insurer impairments and prevention of insolvencies.

Senator BRYAN. Thank you very much.

Mr. Sigerson, we are going to ask you a couple of questions first, sir. Could you tell us the circumstances? How it came to pass that you decided to buy the policy with Executive Life back in 1971? Can you tell us how you were solicited? How you came in contact with them? What your thought process was in acquiring that policy, when you did back in 1971, as I understand it from your testimony?

Mr. SIGERSON. I had been in the manufacturing business for 35 years, a major supplier for General Motors and Chrysler. I merged with ITT in 1980. My own employees all had a good plan. As the owner of a small business, I was able to set aside a retirement pension plan for myself, $141,000. I was looking then for a retirement plan that would bring me in 10 years enough money to perhaps to take me to my guesstimated date of living ambitiously to 90 years old.

I had been counting on this to supplement my income from my investments, which were mostly tax free bonds. So, I looked as carefully as I could, sought the advice of everyone that I could, to find out, which was in April of 1981 or 1982. The Los Angeles Times ran a terrific story of Executive Life, saying that they were the largest company of its kind in California. It was solid; it was this, it was that. Every person that you talked to said this is the place to put your money, and that is why I did.

Senator BRYAN. Mr. Sigerson, when you said that you talked to a lot of people and that virtually everyone you talked to suggested that you do so, I am not so much interested in the names of those people, but are you talking about business associates or friends? Are you talking about investment advisors? Are you talking insurance agents? Can you be a little more specific?

I understand how you read that article and were impressed with what the Times had to say about Executive Life, but what types of folks were you talking to to get these impressions and recommendations that you have described?

Mr. SIGERSON. I asked Stephanie Hibner, who is someone I had met, worked for one of the big companies, a principal company, and she was very persuasive in telling me how this money would mature. And I checked it with the bank, the Bank of America, which I have run with for 50 years, and no one said anything differently.

And that is why I got into it, and I think that is why 400,000 people got into it, because it was touted up until a few years ago as the best place to put your money. No one told you any different. There was nothing that indicated any different unless you stopped—I had stopped reading Barron's and Wall Street Journal.

I was running a small foundation in education, so I just went with it on the recommendation of people who were respectable, and who obviously knew a lot about the business and had been in it a long time.

The fault was mine. I thought I was a shrewd businessman. It turned out that I was gullible, at least to the point if I had gotten out about 3 months earlier, but they put on a tremendous amount of pressure—Executive Life did—to those holders such as myself at 81, not to take out the cash value, to stay in because the tremendous increases in income, interest, and so forth, were guaranteed. And that is why I stayed up until I found out what bad shape they were in.

Senator BRYAN. Let us go to 1991. I guess that is when you really began to press and were real concerned about the security of your investment. It was not altogether clear to me—and I just want to make sure this record is clear—you had agreed to accept $86,000 less than what you would have been entitled to when this plan fully vested sometime later in May; am I correct, sir?

Mr. SIGERSON. That is correct.

Senator BRYAN. And you made a request to get that money when, April, March? When was it?

Mr. SIGERSON. April 4.

Senator BRYAN. April 4 you contacted Executive Life and said, "Look, I will be prepared to accept"——

Mr. SIGERSON. Very shortly after April 4 they send you the request. But about April 2 the Los Angeles Times ran a story which showed that they lost a lot of money. Well, I was enough of a businessman to start looking at it. And so I spent the next day anguishing over whether to cash in at $370,000, which was a lot better with the operation. It is going to cost about that much. And I could not gamble until the last of my anniversary days, which was 30 days away.

Senator BRYAN. So, you requested the $370,000. And on April 11 the insurance commissioner in California took over the Executive Life of California in the conservatorship. Had you received any portion of that $370,000 from April 2 until April 11?

Mr. SIGERSON. No, I had not. I had, I thought—although, by this time I should have been aware. I had the guarantee of several of the executives, the president, that if I cashed in at cash value $370,000, I would be paid very shortly. I could not get them to define how shortly, but it was something like a week or two. The next day at 11 o'clock they were shut down.

Senator BRYAN. Now, originally, as we understand it from previous testimony, the conservatorship and the operating parameters of that conservatorship initially indicated that none of the annuitants would receive any money at all. Thereafter, as we understand it, the order was modified so that one receives 70 percent of the annuity to which he or she would otherwise be entitled.

Your situation—because you were not fully invested, what, if anything, were you led to believe that you will receive on an ongoing basis?

Mr. SIGERSON. For a long time, it was in question. You know, the law said that as of January 1, 1990, when the law was passed, an impaired company would not be allowed that. I do not think they really know. I do not think they are going to know until the end of a quarter when things are taken up. But at this point, there is no guarantee—only hope—that the company will be declared unimpaired, at which time, then, from what I would get, I would be less than $100,000.

Senator BRYAN. Mr. Sigerson, let me get—I did not hear the last part of your comment. It is our understanding that there is that legal issue that the guarantee association went into effect in January of this year and that the legal issue, if a company is insolvent prior to that date it apparently will not be protected with the provisions of the guarantee.

So, the threshold question will be, from a legal point of view, Was Executive Life insolvent prior to January 1? We understand that issue and, obviously, there is even some legislation, so we are led to believe, that may be being considered in California to clarify that.

My question, and I may have missed your point, What are you being told that you are going to receive? I understand that there are no guarantees with all of this uncertainty. But I mean, are you led to believe that you will be receiving some monthly payment in the near-term, or do you have any kind of representation or understanding?

Mr. SIGERSON. There has been no statement by anyone. Garamend—yesterday, I gather—said that he felt there was a chance. That is all anyone has said. And it seems that no one can really make a decision until they have done a lot more book work, which would be probably the end of the quarter. And it is very iffy. Very iffy, indeed.

Our group has been writing to State senators. We have written over 1,000 letters, so far, asking them to support the situation, to be sure that the insurance lobby which at different times worked for Executive Life, and as a matter of record, they sent $250,000 and another $100,000 here, with the lobbyists of Executive Life. So, there is a strong, dynamic force.

A big feeling is, among a lot of the people is, well, it is just too bad about Executive Life. But let us go on for the future. Those guys, they have had their bad luck. And so I would say—I am not a betting man, but I would say the chances are less than 50–50 that that will come through. And that is what I have been led to believe.

Senator BRYAN. Thank you very much. That is very, very helpful.

Mr. Sigman, it looks like the leverage buyout mania of the 1980's has claimed another 2,500 victims in the 1990's, from what you have been sharing with us. Would you tell us a little bit more in detail—your written testimony was a bit more detailed. But tell us a little bit about ERISA and what criteria, if any, under the existing law exists before an employer can make a determination to terminate the existing defined benefit plan and get involved with one of these high-risk operations and then take out that amount of the retirement which seems to be in surplus.

That apparently was one of the inducements that made this a takeover target, as I understand from your testimony. Can you tell us maybe just from a practical experience what happens not just in the case of Pacific Lumber, but how that operates?

Mr. SIGMAN. Well, what happens, essentially, is that the law allows a company to terminate a pension plan and to recapture so-called surplus assets in that process. And unfortunately, I think when Congress first enacted ERISA in 1975, no one really foresaw the junk bond mania or just the infatuation with debt that we have witnessed during the last decade.

But ERISA does regulate the transaction to the extent that the decision to place—after a plan is terminated—that the decision to place the group annuity contract is a fiduciary decision which is subject to the requirements of ERISA. And it is actually that basic protection that ERISA still provides in this area that we are pinning our hopes on in terms of the litigation. And in the context of litigation, we are examining very closely the decisionmaking process, what information was available to the company, what information they chose to ignore.

But the bottom line is that ERISA allows these terminations. It allows companies to recapture all these assets. And I would have to add that the Department of Labor has—although it has investigated—has not really taken a position, at least not in terms of intervening or bringing its own action in regard to any of these terminations and replacements of group annuity contracts with Executive Life.

Senator BRYAN. Does the Department of Labor, through ERISA, make a determination as to what amount of money or investments in the plan constitute a surplus above and beyond that which is necessary to satisfy the obligation, or is that simply a determination that the employer group who is contributing into the plan makes themselves?

Mr. SIGMAN. Well, under the statute, the employer, in conjunction with the plan's actuaries, makes that determination as to what funding would be required to meet ERISA's minimum funding requirements.

Senator BRYAN. Does that require ERISA to exercise its independent judgment at that point, or is that just a declaration they make, and then they are able to go forward and terminate the plan?

Mr. SIGMAN. ERISA requires the plan's actuary to exercise independent judgment. I think, however, in situations where actuaries perform other services for the plan's sponsor where they may have major business interests in terms of maintaining that relationship with the company, that—at least in my experience not particularly in this case, but in other situations—the independence of the actuary is somewhat less than plan participants, I think, are entitled to expect.

Senator **BRYAN**. Now, with respect to those plans that are not terminated, as I understand, the PBGC, the Pension Benefit Guarantee Corporation, does provide some protection for those who are intended beneficiaries under the defined benefit plan. Could you tell us what the scope of that protection is and how that works?

Mr. **SIGMAN**. Well, simply put, the Pension Benefit Guarantee Corporation stands as a Federal guarantee fund, if you will, behind these defined benefit plans. The statute does not require the Pension Benefit Guarantee Corporation to fund, at a full level, the benefits that were promised. But it does provide at least a minimum floor. And it provides that these benefits be paid immediately upon the distress termination of a particular plan by the PBGC.

Senator **BRYAN**. And what is the floor, and how does that operate?

Mr. **SIGMAN**. It is a percentage formula, and it depends on the amount of benefit that an individual participant is entitled to receive. I cannot give you the percentage breakdown, but it is basically based on the same concept as the graduated income tax. Those people that stand to get a higher benefit would suffer a larger reduction, the idea being that there should be at least a minimum guaranteed benefit that the PBGC would provide.

Senator **BRYAN**. So, it is a percentage of the benefit that they would otherwise be entitled to receive, as opposed to a flat dollar amount akin to the old FSLIC for savings and loan, the FDIC, the NCUA, with respect to credit unions where there you have got $100,000 account.

Mr. **SIGMAN**. Right.

Senator **BRYAN**. And, you know, if you are heirs to the J. Paul Getty fortune you still get $100,000 just as if this represents the cumulative life savings of a family for many, many years.

Mr. **SIGMAN**. Well, essentially, the PBGC, once it terminates a plan pursuant to the distress termination procedure, stands in the place of the plan. And the pensioner then receives his or her monthly benefit from the PBGC directly.

Senator **BRYAN**. Now, you have made several recommendations here, all of which we have for the record here, some five recommendations. Have you had occasion to discuss any of those with any of the folks over there at the Department of Labor or any of the folks that are involved generally in the insurance industry? Would you share with us what you have done and what the reaction has been?

Mr. **SIGMAN**. Well, I have not had the opportunity to discuss, specifically, these recommendations with either a representative of the PBGC or the Department of Labor. I do plan on meeting with representatives of the PBGC tomorrow, and I hope to share some of my observations with them then.

Senator **BRYAN**. Well, we very much appreciate your testimony, Mr. Sigman.

I am going to try with your name again, Mr. Sarfaty?

Mr. **SARFATY**. Sarfaty.

Senator **BRYAN**. Sarfaty. Mr. Sarfaty, you were talking and you said that historically this guarantee association system has worked pretty well and has protected those who purchase insurance. And I suspect that that is probably true. I have not researched the record. But we have never had losses of this magnitude, as I am sure you would agree. Mr. Sigerson makes the point that there are several hundred thousand people potentially at risk in every State, 50 billion dollars' worth of coverage.

It seems to me that maybe we have moved to a higher plateau or are dealing with losses of a greater magnitude than we have heretofore experienced with respect to our insurance system. If you agree that that is the case, are you still comfortable that, as you said in your testimony, the losses will be small? Because Mr. Sigerson places a much different perspective as a victim of this thing. He seems to think it is very little likelihood his folks are going to get——

Mr. SARFATY. Well, I would like to explore with Mr. Sigerson the type of coverage that he has. There are differences, as I averted to in my testimony, but I understood from your staff that we would not have the time fully to develop some issues.

Senator BRYAN. No.

Mr. SARFATY. But our protection concentrates on the individual contract. It is not generally our objective—and that does not mean what we may prefer, but the way the laws are structured—in effect, to guarantee hot money that may be chasing the highest interest rates in huge chunks of $50 and $100 million around the country as happened with the savings and loans, and that some pension trustees, perhaps, either acting on very poor advice or ignoring good advice——

Senator BRYAN. And at least one life insurance company that we know of that was involved in that very——

Mr. SARFATY. They were in effect, I am sad to say, the repository of some of that hot money, I think. That is very unusual in the life insurance industry. I think that it is a bit of a barn door, of course, but we all wish we knew before what we subsequently learn. State insurance regulators have been tightening the extent to which junk bonds may be purchased by insurance companies very substantially.

But the insurance industry historically, and even still very much, is a highly conservative investor. And behavior of the type that it appears Executive Life engaged in is quite unusual. The types of losses that I think some people are frightening themselves over, we do not think are going to come to pass, certainly for individual annuitants or for persons who had certificates directly from the company.

We think that we will be able, working with the conservator, to keep these losses to a very minimal extent, except perhaps for some people who had very large policies of the same type that—the same idea that you just suggested with respect to a relatively wealthy individual versus someone who is not quite so fortunate. But with respect to those contracts that were basically naked investment contracts that were purchased by pension plans or by other entities for purely investment purposes and which carried virtually no incidents, really, of traditional insurance as we understand it from the individual's point of view, which is the purpose of our protection, I cannot say, with respect to those folks, that they will receive the same level of protection or return.

But for the vast majority of policyholders, I think they should not panic, and none of them will be wiped out, and they will see a very, very substantial return.

Senator BRYAN. Well, we do not want to see anybody panic either. And we want to see that those losses are kept to a minimum. But I do look—this is an article that appeared in the Wall Street Journal after a revision was made by the National Association of Insurance Commissioners as to what portion of some very large insurance companies' portfolio consists of junk bonds.

And you are familiar with that. First Capital goes from 20.2 to 40.7 percent; Fidelity Bankers from 18.3 to 37.6 percent; United Pacific from 14.3 to 32.9. And the list goes on and on to cite, you know, just several companies. Now, my understanding——

Mr. SARFATY. I think there is an important point with respect to that. Fortunately, not all so-called junk is equal. There are bonds that used to be investment grade, and because of adverse circumstances of the issuer are now rated slightly below that. And they would come into that now general basket. But what the NAIC has done is further subdivide those categories. And so there are many more bonds that now fall into that category overall than used to.

But some of them very much need to be differentiated from others. There is some junk that is truly junk and virtually has no market. That is at the bottom. And there are others, and many others, that still have very substantial value and are very likely to fully perform.

Senator BRYAN. Now, with respect to the person such as Mr. Sigerson was trying to purchase an annuity, can you tell us generally what protections are afforded by these guarantee associations, recognizing that there are some changes from State to State. But as your testimony points out, there is generally a pattern that seems to be somewhat similar around the country. In general, are the pensioners, the annuitants—are they covered under the guarantee association provisions?

Mr. SARFATY. Anyone who has been receiving periodic annuity payments under an individual annuity policy with an insurance company will receive, in effect, at least 100,000 dollars' worth of protection.

Mr. SIGERSON. In my case, I received no——

Senator BRYAN. Mr. Sigerson, let me just finish with Mr. Sarfaty here.

Mr. SIGERSON. I am sorry, sir.

Senator BRYAN. That is all right.

Mr. SARFATY. It is, unfortunately, a little difficult to address all of the possible variations in the time available to us. And I would be very happy to sit down with Mr. Sigerson and his group and, in fact, invite them to do so.

Senator BRYAN. I think you sealed an agreement right before our very eyes.

Mr. SARFATY. Absolutely.

Senator BRYAN. And the record will reflect that Mr. Sigerson and Mr. Sarfaty shook hands and they agreed to sit down and personally review the situation. Let me just continue, Mr. Sarfaty, just so we do not break up this line of questions. So, you believe that most of the annuitants, then, are going to get some of the protections of the guarantee association?

Mr. **SARFATY**. Yes, I do.

Senator **BRYAN**. Now, may I take it that the GIC's, the guaranteed investment contracts, are beyond the pale of the protection? You seem to suggest that.

Mr. **SARFATY**. Not all of them, in all cases, to all extents.

Senator **BRYAN**. OK.

Mr. **SARFATY**. Some of them may receive no protection whatsoever. Others may be fully protected. And still others may fall somewhere in between. They were all types. And there are, as I indicated in my testimony, differences in the types of coverage under different State laws for those types of products. Those differences are far more pronounced than with respect to the individual type of annuity product that most of us as individuals would purchase.

Senator **BRYAN**. Now, Mr. Sarfaty, what you are describing—and we appreciate that you have to be general, because there are variations. And I do understand that. But what you are suggesting is that obviously some of these are going to have to be a case-by-case review, that the laws in State A may be different from the laws of State B. And indeed the particular type of insurance instrument is going to have to be examined to see exactly where it fits within the various criteria. And we understand that.

Now, that means that there are going to be, in the case of Executive Life, several hundred thousand people that will be potentially affected by the decisions that guarantee associations make. I want to talk to you a little bit about the operation of the guarantee associations without in any way maligning its record in the past. We are not talking about that.

But it is true, is it not, that in many States the guarantee associations do not function as agencies of Government generally do, subject to open meeting laws where notices are posted and the public and the media are permitted to attend and to report on the proceedings? Correct me if my impression is in error, but that is my understanding, that not all States have these guarantee associations that are even open to the public, because these kind of decisions are going to have a profound effect on Mr. Sigerson and his policyholders.

Mr. **SARFATY**. The decisions affecting any individual policyholder are fully subject to review by that individual policyholder. And decisions are further subject to review by State authorities, subject fully to State hearing requirements of the kind that you are so familiar with in the Federal Government level. So, that is not the case. What is true——

Senator **BRYAN**. Well, let me very specific, because I do not want to let you slide edgewise on me here. I am talking about the decision, initially. In other words, let us say guarantee association in State X, hypothetically, has now got this issue before them. Let us assume, for the sake of argument—hope it is not the case; everybody in this room does—that indeed a determination is made that this company is insolvent.

And so that being the triggering device in most States for the insolvency. And so the guarantee association board is meeting. My question, specifically, to you is, Does that meeting require public notice? And is it open to all of those who might be affected, or anyone else who has an interest?

Mr. SARFATY. Most States do not have laws requiring that the guarantee association boards' meetings be open. They do provide that they may be opened. However, these meetings often do involve discussion of matters that are confidential to policyholders. And those matters are not public matters. If an issue arose respecting Mr. Sigerson's contracts or his medical condition, his own financial condition, that would not be a matter that is subject to an open meeting or for, frankly, the Wall Street Journal.

The issues, however, respecting—you started by saying that a case-by-case review would have to be undertaken. That is only true in the sense that we have to sort out the types of contracts that are involved.

Senator BRYAN. I understand.

Mr. SARFATY. That will not involve—that will basically be done, in large measure, by computer sorting.

Mr. SARFATY. There are some issues that will be subject to decision. And we hope we will be able to have these decisions made as uniformly as possible among the States, and in conjunction with the conservator, and possibly, too, for eventual decision by some of the courts as to which types of contracts will be accorded what type of priority under the state priority provisions of their liquidation act.

Senator BRYAN. But my point is that under the existing law those are not, those discussions of the boards of directors or however they style themselves, and the guaranty association, those decisions are not subject to the traditional open meeting law requirements.

Mr. SARFATY. No, that is not true. The traditional open meeting requirements do not discuss private financial matters in public.

Senator BRYAN. No, no, but Mr. Sarfaty, you are playing a game with me.

Mr. SARFATY. No, I am not——

Senator BRYAN. Excuse me. I am talking about general, I am not talking about the details of Mr. Sigerson's health.

Mr. SARFATY. Remember you spoke about a triggering mechanism?

Senator BRYAN. Yes.

Mr. SARFATY. Now, and you spoke of an order of insolvency. We do not have an order of insolvency with respect to.

Senator BRYAN. I understand that.

Mr. SARFATY. Now, we would not even be able to get any information on this company now if we were not able to respect the privacy and confidentiality requirements imposed by the California conservator. That is the type of issue. It would not be fair to characterize this as some kind of secret proceeding. That is just not what is at issue.

Senator BRYAN. I understand. No, but Mr. Sarfaty, I made the point, and I think you acknowledged it initially, now you seem to be backing off. These decisions—I am not talking about the circumstances of Mr. Sigerson's health or his financial—but generally speaking, the decisions as to which general category thousands of contracts may fit into, that in effect that decision does not have to be made in an open meeting subject to the open meeting law.

Mr. SARFATY. No, no. And if I gave you that impression, I apologize.

Senator BRYAN. It does? The guaranty association is subject to the open meeting law? Just "Yes" or "No."

Mr. SARFATY. Maybe there is an imbedded premise in the question that I simply cannot grasp.

Senator BRYAN. But is it subject to the open meeting law? We want to go onto other questions, but are they generally subject to open meeting laws?

Mr. SARFATY. No.

Senator BRYAN. OK, that is all we need to know. Now, with respect to your responsibilities, I mean obviously you want to prevent, as we all do, do you have any thoughts as to what ought to be done to prevent the recurrence of this type of thing? We hope it will never happen again, that is your hope; that is my hope, that is everybody's hope in the Congress and in this room.

Are there things that we need to do? And does your group make recommendations specifically about changes, either in the regulatory structure, State law, Federal law? And if so, we would welcome them. If you do not have them today, we can certainly leave that open for you to respond in writing. But in general, do you have any recommendations?

Mr. SARFATY. Well, I did make reference to two items in my opening remarks that I think would be very helpful. I should emphasize that the system as it is currently structured differentiates the functions between prevention and detection and guaranty. We do think that is a useful distinction, and that it does provide a check and balance mechanism.

That does give us an incentive, a very strong incentive, in effect to watch over, to provide comment, and to take some measure of the effectiveness of the prevention and detection functions of the State regulatory authorities.

And in turn, it allows them to watch over us and to see how we are performing. And one structure or body is not responsible for both of those functions. But we do obviously have a very keen interest on how well the prevention and detection functions are performed.

Senator BRYAN. To the extent that your group has any recommendations, we will certainly leave the hearing record open on this. We certainly invite your comments as to anything that has been said by any of the witnesses in these hearings that you agree with, or those things that you disagree with.

Mr. SARFATY. There are some comments with respect to the role of the Federal Government, maybe I should characterize it as a patchwork of Federal requirements that has, I think, left a substantial degree of inconsistency with respect to its treatment of financial security, long-term financial security products, that does affect us.

Earlier witnesses spoke of the very unfortunate timing and actions of the Internal Revenue Service, in this matter. We have had some very, we think, ill-timed and ill-considered interventions by the IRS in other cases which are basically along the lines of kicking you when you are down.

Concerning the PBGC, I had the opportunity to work at the Labor Department back in 1974 when ERISA was just enacted. I would personally have hoped that it would have evolved a little better in the time since. I think there are a number of recommendations that we would be happy to make.

Senator BRYAN. Mr. Sarfaty, Mr. Weiss offered some comments at the hearing we had on Tuesday; you may not have been in attendance. We will provide those to you and would welcome your comments, or Mr. Sigman's comments.

Just two last questions, if I may. Now, the composition of the board of directors of guaranty associations, are those individuals who are impressed with the public trust, such as insurance commissioners or State appointees in the sense of having a general fiduciary responsibility to the public?

Or are these individuals that are in the private sector and, not impugning their motives, nevertheless do not have a public responsibility or a mandate imposed upon them by law? Who are the members?

Mr. SARFATY. No, it is the former. They are appointees or approved by public agencies and they do have obligations imposed on them by law. Generally speaking, they are selected among the insurance companies that write business in the State, and the law provides that they shall in the aggregate provide a fair representation of the industry to assure that its expertise in the types of business for which the association is charged to provide protection is available in that association, to operate it in an efficient manner.

So, that means that Commissioner Garamendi, for example, will assure and did assure that there are health companies of various types representing various segments of the market, life companies, annuity companies, et cetera, California companies, other State companies, so that he and the public and the association and all of its members are assured, and all of their policyholders are assured that the expertise is there.

And there is another interesting aspect of it. They watch each other. The impact, the financial impact gets very widely distributed among the industry. And so the fairness of that impact is something that is always being hotly debated.

Senator BRYAN. Am I correct in taking from your testimony that they are essentially industry representatives on most of these guaranty boards?

Mr. SARFATY. Yes, that is correct.

Senator BRYAN. Is there any requirement generally, recognizing that there may be distinctions from State to State, that there be public membership on those? What is the general——

Mr. SARFATY. You mean somebody who does not know anything about insurance?

Senator BRYAN. Somebody who might be there to protect the public is what I had in mind, Mr. Sarfaty. [Laughter.]

Mr. SARFATY. Well, the guaranty board and insurance commissioners—I am sorry, I guess I did not understand your question.

Senator **BRYAN**. Well, let me go over it again. I am asking is there any requirement in these guaranty association statutes that requires someone other than industry representatives to be——

Mr. **SARFATY**. Oh, yes, the association is under the immediate supervision of the insurance commissioner, and all of its decisions are subject to appeal to the commissioner and then to the courts.

Senator **BRYAN**. How about the board itself, though? That is my question. Without the appeal process, just the board.

Mr. **SARFATY**. In general, not.

Senator **BRYAN**. Generally not? There is generally no public membership?

Mr. **SARFATY**. Yes, right.

Senator **BRYAN**. Now, you talked about the cost. How are the costs passed along to the public?

Mr. **SARFATY**. No, let me just state, there is generally no membership other than insurance industry representatives.

Senator **BRYAN**. And I think you made that point, and I think the record is clear. How are the costs passed on? You talked about the enormous costs that are involved, and very clearly there are substantial costs when you have a big failure like this. How are those passed on?

Mr. **SARFATY**. Well, it does depend on a number of things. It depends on the line of insurance, the type of policy. It depends on whether there is a tax offset provision in the statute for that particular State, and what the characteristics of that statute are, et cetera.

In other words, some of the cost is in effect reflected in increased premiums. There are obviously many types of contracts, like life insurance contracts where you cannot raise the premium, the premium is fixed. So that would then be passed on to new policyholders in higher premiums, offset against the tax over an extended period, along the lines of the deductibility of a bank's FDIC premium. That same general idea, if that is available in that State.

Lower interest rates on interest-sensitive products is another way it gets passed on. Lower dividends. So, naturally it spreads through the entire system. There is simply no free money.

Senator **BRYAN**. So, ultimately the public does——

Mr. **SARFATY**. Ultimately the public pays for everything.

Senator **BRYAN** [continuing]. Either in the form of lower dividends, lower interest rates, perhaps higher premium, depending upon the product.

Mr. **SARFATY**. That is correct. That is absolutely right.

Senator **BRYAN**. And ultimately the general fund of those States that permit offsets would have an affect.

Mr. **SARFATY**. That is absolutely right.

Senator **BRYAN**. Let me give you one last question. We have got another panel here. Go ahead, Mr. Sigerson.

Mr. **SIGERSON**. I am sorry. Out of my inexperience, and not because of my age, I forgot to mention, or did not mention, the group that we are. As far as we know——

Senator **BRYAN**. You have been anxious to hold up that sign, Mr. Sigerson. Let me give you a chance to do so. Why don't you hold up that sign for a moment there? You got it right there. Go ahead, let him hold that up. That is the name of your group right there. Executive Life Support Network.

You have got the, I think we all know who you are now, and we very much appreciate your testimony, and you all have done a splendid job. I thank you, sir. I thank you, Mr. Sigman. And thank you, Mr. Sarfaty. It has been helpful. You all have been clear. Thank you very much.

We will now hear from our next panel. Mr. Tom Borman, who is a former commissioner of the State of Minnesota; Mr. John Washburn, a former commissioner of the State of Illinois; and Mr. Thomas C. Sutton, who is the chief executive officer of Pacific Mutual, representing the Council of Life Insurance. And we are delighted to welcome you gentlemen to the table.

Gentlemen, thank you for your patience with us. We need to build a record here, and we are delighted to have you here with us today. Mr. Washburn, you are the former commissioner from the State of Illinois, and as such, why don't you share with us your observations and reflections and hindsight? And we will get your former colleague from the State of Minnesota, is it Mr. Borman?

Mr. BORMAN. Yes, sir.

Senator BRYAN. OK, we need to make sure that that, I did not know whether we had a substitute. You are being identified here for the world as Mr. Orman. We sure want to correct that. Mr. Borman, your family will be quite concerned if they saw the wrong name identified with you, sir.

Mr. Washburn, why don't you begin? And we have got your testimony in the record, and we will make all of your testimony a part of the record, but let us hear from you.

STATEMENT OF JOHN WASHBURN, FORMER ILLINOIS COMMISSIONER OF INSURANCE, CHICAGO, IL

Mr. WASHBURN. Thank you, Mr. Chairman. I am flattered by the opportunity to appear today. I should say right off that I am John Washburn, I am now vice president of several insurance subsidiaries of the Aon Corp.

Though my testimony here really does not reflect anything I have learned in my 3-month tenure with Aon, as I am relatively new and have not been involved in the life insurance business at all.

First of all, I was instructed to talk about generally what I see of the life insurance industry, and how I look at the regulatory circumstances of today and whether I think they are sufficient. Let me start out by saying the life insurance industry has dramatically changed over the last 10 years. And although it had very good health 10 years ago, it still has good health but its profit margins are very much squeezed between yesterday and today.

Part of that is just the marketplace. Investors have got a lot more ability to maximize the investment of their dollars, and there are a number of new investment vehicles. Some of the investment vehicles that the life insurance industry relied on were no longer competitive in the marketplace. And so what they had to do was either decide to compete in the marketplace or retreat, just get out. A number of companies chose competition.

The competition put a host of competitive problems on management. This was sort of a brand new world they were into, and there were no real good signposts for how you succeed in this new environment. And indeed today there are probably still not very good signposts. Management had to develop new products that were competitive but were also profitable.

Now, prudent management allows for errors. But the profit margin, the shrinkage of the profit margins really reduced the amount of error that was allowed management. And a competitive marketplace dictating on management could really cause some major problems.

I think the financial gain for investors over the last 10 years has been worthwhile, but I think that such financial gain did bring new risk involved. And the challenge for both management and regulators was how do you achieve this gain for investors without causing a great deal of distress for the investors who are involved in this marketplace.

Management has to do that just to try and make the company survive, but it has got competitive pressures that may change their viewpoint. Regulators have to do this, and they have got to do this in a way that really protects the small investor, protects the investors, and they should not have any pull from this competitive atmosphere.

Now, regulators and management I think will both admit that there is no sure-fire method for doing this if you are going to have a competitive marketplace. There are going to be problems that come up in a competitive marketplace that cannot be foreseen. And so what the regulators tried to do was set up a guaranty fund structure. Basically the thought was the guaranty fund structure would mitigate those problems for small investors, for the investors and policyholders.

Now, whenever you have a problem in the insurance industry, questions are asked as to the regulators' ability to deal with those problems. This is especially true I think with insurance, because it is run at the State level. You always hear the press talk about this patchwork of insurance regulation. Part of this is certainly legitimate; part of it I think is, there is a theory that if it is not done in Washington it cannot be done well.

I think I would like to answer that sort of in two ways. First there are just some components you need in any regulatory structure no matter where it is or no matter how it is put together. The first component is you have got to have people who are smart, who like their job, who are doing a good job of it, and who are sort of challenged to do that job. And I think you find that in insurance regulation today.

There are close to 7,000 people involved in regulation of insurance today. There are a number of people involved in the regulation of insurance who are smart, who like their job, who have been doing it for a number of years, and with all due respect to my colleague here, I am not talking about commissioners. I am talking about the staff of the insurance departments who have been doing this for in some cases 20 or 30 years. They are still challenged, they are still motivated, and they are still very, very smart.

And the second thing you need, no matter how you try and set it up, is a regulatory structure that is continually looking to change itself with the marketplace; that is continually looking to make sure that it is on top of the issues. I think there you have got the NAIC really providing a very valuable tool for that, for developing that framework.

Every State puts together a statutory framework for regulation, and then you have got rules and you have got sort of norms. The NAIC really forces you to challenge all those statutes and regulations and have them under constant scrutiny. And they are under scrutiny of those people who are involved on day-to-day regulation. They are under scrutiny from all the members, all the staffs through the NAIC.

The NAIC is more than just a forum for ideas. It provides crucial information and coordination for all the States. So, the NAIC has a certain strength in just the type of system it has evolved. And one last thing I think that state regulation has a strength in that you do not find in most others is the ability to innovate or the ability to act on your own.

It is sort of like a feudal system. We are all princes. We can act on our own, whether the NAIC wants to act or not. And what that does for this system is we are able to innovate. In Illinois we would enact laws or changes in rules just to see if they worked, to see if they hit the desired intent, to see whether they were more onerous than they were valuable, to do a whole series of things which we could start in Illinois without causing any problems in the rest of the structure. It let us all sort of be laboratories for regulation.

The second thing it means is when you have a troubled company, you really have to respond to the other regulators because each one of us can act on our own if we really desire. And each one of us can look at how we think that company ought to be regulated. So for a lot of regulation of troubled companies, you have sort of an oversight by your peers on how the regulatory system ought to go.

I am not trying to tell you that there are not problems or problems will not come up, or problems are not present in Executive Life. But I am just saying what you have got now is a structure that does try and take a look at these problems, it has got smart people involved, and it has got a framework to do it. And so what I think it needs more than an overhaul is something on exactly where they ought to be focusing, what is the intent that everyone wants to have with regulation, you are going to have troubled companies.

If you do not want troubled companies, you have got to stop a competitive marketplace. One or the other. But you, the real question you ought to ask the regulators is not whether they move on a large company, it is how deep a hole that company is in before they move. Thank you, Mr. Chairman.

[The prepared statement of Mr. Washburn follows:]

PREPARED STATEMENT OF JOHN WASHBURN

Mr. Chairman, Members of the Committee, I am pleased to be able to come before you today and lend you any insight I have that may be useful to the committee. My name is John Washburn. I am currently a Vice President of several insurance companies of Aon Corporation, a $10.4 billion insurance conglomerate. Although there are several life insurance entities within Aon, my remarks are not from any knowledge of those entity operations, as I have no dealings in the life insurance area in my three month tenure at Aon. My remarks come from observation as Director of Insurance for the State of Illinois, a position I held from 1983 through September of 1989. In 1987 and 1988, I was also Vice President and President of the National Association of Insurance Commissioners (NAIC).

First of all, let me say that the life insurance going into the 1980's was healthy, and is still healthy today. But it is certainly under more pressure in today's marketplace to maintain that health. The life insurance industry was in the midst of change when I became Director; and that change continues through to today. The marketplace changed in the 1980's for the industry's most stable and profitable product, the whole life product. The public gained greater awareness of how to maximize their investment dollar. Investors, also, had a vastly greater range of products to choose from in attempting to achieve that goal. The old whole life product was not competitive in that world.

The life insurance industry had to compete or leave the field and restrict themselves to the selling of life protection only (the term life products). A great majority of the industry chose competition.

This competition put a host of strains on management and their systems. Along with other financial entities, this was a brand new world they were entering, and there was no set path to success. Management had to develop new products that were not only competitive, but also would be profitable. The long-term nature of these products make estimates of profit; just that—estimates. And, such estimates are only as good as the underlying assumptions. For example, one assumption is buyer expectation. If management views its products as long term and buyers expectations are short term, there may be problems in the assets management uses to achieve the investment goal. That is only one of a myriad of assumptions underlying new products.

Prudent management allows for a margin of error. But innovation and a competitive marketplace can cause problems.

The financial gain for investors (most especially small investors) of new products and with heightened competition for his or her dollars, has been great. But, there is an increased risk.

The challenge for both management and regulators is to eliminate this risk. Management has this charge to ensure their company survives. But their charge is tempered by the nature of the competitive marketplace.

Regulators have this duty to protect the investors/policyholders; and they can do this without the pull of daily competition.

Both regulators and management realize that not all hazards of this new world can be foreseen. And, for this reason, a fail-safe mechanism has been adopted in most states and is constantly being refined. It is called a guarantee fund. Its objective is to allow competition without unduly penalizing the individual investors. There are states without such a fund, but I expect that they will now adopt such a policy with the problems of Executive Life.

Whenever problems in the industry appear, questions are asked as to the ability of the regulatory structure to handle its task of citizen protection. This is especially true of insurance, because it is regulated at the state level. The press loves the term "patchwork of insurance regulation".

Part of this inquiry is legitimate. Part, I suspect, is caused by a notion that if it is not done out of Washington, it cannot be done well.

I am sure others have availed themselves of the opportunity to explain the state regulatory system and its ability to work together. I would like to talk about the issue in two ways.

First, it does not matter how the regulatory system is put together. Several components are essential. The first is people—the regulators. It has to have smart people, dedicated to their jobs, who are good at what they do. The state regulatory structure has these people. With all due respect, I am not talking about the three of us at this table. I am talking about the real regulators—the staffs of the departments. There are a number of exceptionally sharp people in a number of states, large and small, who are involved in the regulation of this insurance business. If you look at insurance regulation in terms of numbers, there are a great number of people (over 7,000, I believe) with expenditures of over $300 million involved in regulation.

No matter what your system, you would still split the personnel up geographically. Indeed, the way they are split up today, insurance regulators are more accessible and responsive to the public than any other regulatory body.

Another essential ingredient for a regulatory structure is a framework which allows these regulators to be effective. The NAIC provides this framework. Every state has enacted a statutory framework for insurance regulation. And these laws are under constant scrutiny and change, not only in the states, but at the NAIC. Such scrutiny and subsequent revisions are essential when the industry is in such a state of change. But the method of change (which through the NAIC allows for a consensus of peers) provides both a challenging and enlightening environment to these regulators who work with these laws and regulations on a daily basis. In arguing out each point of view, in deciding on the priority such changes should have in each state's legislative package; and in explaining them to each state general assembly, the regulators are challenged and have the ability to impact their regulatory framework.

The NAIC is more than just a forum for ideas; it provides crucial information and coordination for all the states. This allows for the most effective regulatory action. This coordination includes not only demanding a consistent annual statement, the basic regulatory tool from all companies to all states; a coordinated analysis of that statement; and special task forces to work on troubled companies; but, also, a computer network including hardware and software for each state.

The system has good people and a good framework, the elements that make up effective regulation no matter which governmental entity has the responsibility. But this system has a strength that is only present in a state structure. Than strength is the ability for one state or several states to act on their own when they feel it necessary. This ability for unilateral action allows for innovation of the state level in regulation. Indeed, we in Illinois often enacted regulatory laws or rules to see if the actual regulatory result was the intended result, and whether such an action was truly meaningful. If we found out it was effective and beneficial, we would then bring it up to the NAIC. In essence, the states are laboratories for regulatory ideas.

This ability of unilateral action also allowed for gradual, though not planned, constriction of markets for troubled companies. In reality, there was a great deal of difference in my ability to stop an Illinois insurance company from doing any business, and my stopping an insurance company from another state from doing business in Illinois. For the Illinois company, such a restriction meant its death. Such an action required my going to court, and to do so I must have ready access to data for proof about the company's condition that can withstand any challenge by the company. For a similar action on a non-Illinois company, it only means a shrinking of its market; and, usually, the company decides it is not worth challenging the regulator. This is an important element in regulation that should not be overlooked. This also means an insurance commissioner must respond to any commissioner from another state in terms of regulatory action, because that commissioner can act on his own. There is a strong peer judgment on regulatory action inherent in the state regulatory system.

In conclusion, I just want to reiterate that the life insurance industry is a strong industry that is going through a time of change due to competition. Although this competition is good for the consumer, these changes cause strain on both management and regulators. There are and will be problems unanticipated in whole or to its degree by either management or the regulators. This does not mean regulators lack the capacity, or will attack these problems prior to their impacting policyholders. The regulators today have both the desire and intelligence; but it is and will continue to be a changing marketplace. For that reason, guarantee funds are put in place in most states; and, I suspect, with the Executive Life problems, will be in all states within the next two years.

Senator BRYAN. Thank you very much, Mr. Washburn. Now that we have got the name correct, Mr. Borman, welcome to the proceeding and we are pleased to have you with us as well.

STATEMENT OF THOMAS H. BORMAN, FORMER COMMISSIONER OF COMMERCE, STATE OF MINNESOTA, MINNEAPOLIS, MN

Mr. BORMAN. Thank you. Senator Bryan, my name is Thomas H. Borman. Last year I was commissioner of the Department of Commerce for the State of Minnesota. As commissioner, I regulated the banking, insurance, securities, and real estate industries in the State.

In testimony before Chairman Dingell last June, I expressed concerns regarding the threat of insolvency at First Executive. I said the benefits of First Executive policyholders were endangered and the failure of First Executive could destabilize the entire life insurance industry. Less than 1 year later, First Executive failed.

First Executive's failure is truly a disaster for the annuitants and pension beneficiaries who may lose a portion of their retirement savings, and for the well-managed companies who will pay dearly through State guaranty associations for First Executive's excesses.

Let me begin by describing my encounter with the California insurance division as the First Executive crisis began to unfold last year. I was appointed commissioner of the department of commerce on January 9, 1990. As a new commissioner, 1 month in office, I faced the following crisis. First Executive had announced a $550 million charge for bond losses. Publicity regarding the company's level of junk bond holdings and its fourth-quarter charge caused policyholders to dramatically increase their surrenders of the company's life and annuity products.

Also during that month, Drexel Burnham Lambert failed and the junk bond market declined 9 to 12 percent. In this crisis environment, I instructed my department to provide me with current information on First Executive's writings in Minnesota and its financial condition. Unfortunately, the information I needed was neither available or it was seriously dated. The most recent on-site examination of Executive Life Insurance Co., the California-domiciled life insurance subsidiary of First Executive, for yearend 1987 had not yet arrived to our department.

Learning that we had no current information on Executive Life, I instructed my staff to inquire directly of the California insurance division for current information regarding Executive Life's liquidity, capital and surplus, and Minnesota exposure in the event of insolvency.

While the California department was under enormous pressure in late January as this crisis unfolded, the fact was that we could not obtain current information from them despite repeated requests. We also disagreed with California's determination that neither a full-scale examination nor a targeted examination of Executive Life was warranted. We could have participated in either one.

As the junk bond market continued to decline, I decided to act. On February 4, 1990, I sent Minnesota's chief insurance examiner and the department's life actuary to First Executive to monitor the solvency position of Executive Life. As a result of this special examination, we required Executive Life to report to Minnesota on a bidaily basis its surrenders and its liquidity position. This direct information proved invaluable as we monitored Executive Life's situation throughout the first quarter of 1990.

I have recommended on a number of occasions that the insurance regulatory community be modeled more closely after the current bank regulatory model. As I indicated, as commissioner of commerce I oversaw both the bank and insurance examinations divisions for the State.

Based on my observations of the workings of both, I have at various times recommended the following changes: No. 1, that there be more frequent examination of troubled companies; No. 2, that triennial examinations, the examination we were looking for on First Executive, be provided in a timely fashion; No. 3, that insurance examinations divisions place more emphasis on credit analysis; No. 4, that companies be required to develop risk rating systems on troubled loans; No. 5, market value accounting for distressed real estate; and No. 6, the use of risk-based capital requirements.

The regulatory process that allows different standards and solvency monitoring capability in each State can no longer be tolerated. This is the process that allowed First Executive to grow. The time has come for all States to enact tough and uniform minimum solvency standards, and to acquire minimum monitoring capabilities.

There are a number of areas where I believe uniform minimum standards will be necessary: investment laws, guaranty funds, reinsurance, accounting and reserving, managing general agents, and monitoring capability.

I want to underscore that I am not arguing necessarily for Federal regulation. These uniform minimum standards can be developed at the Federal level and you can require the States to adopt them. The NAIC is currently working on solvency standards and monitoring accreditation. Ultimately I believe they will develop a strong product.

A third approach involves a hybrid of the first two, and is one that I proposed to Congressman Dingell. Leaders of the House and Senate could cause formation of a taskforce of industry executives, regulators, and representatives of consumer groups. This taskforce could be directed within a 4- to 6-month period to reach agreement on a uniform set of minimum standards for solvency monitoring.

This approach has worked in Minnesota. A group of 10 CEO's and members of my department drafted a comprehensive reform of our State's solvency monitoring capability. This was done in only 4 months. The report will be enacted by the Minnesota Legislature, and includes among a number of recommendations the toughest junk bond limit in the Nation, market-to-market accounting, and reserving for distressed real estate, risk-based capital requirements, and an industry commitment to pay for more department staff.

I would be happy to answer any questions, and I do appreciate the opportunity to testify before you today.

[The prepared statement of Mr. Borman follows:]

PREPARED STATEMENT OF THOMAS H. BORMAN

Mister Chairman, members of the committee, my name is Thomas H. Borman. I am currently a partner at the law firm of Maslon Edelman Borman & Brand in Minneapolis. Last year I was Commissioner of the Department of Commerce for the State of Minnesota. As Commissioner, I regulated the banking, insurance, securities and real estate industries in the State of Minnesota.

I appreciate the opportunity to testify before you today.

In testimony before Chairman Dingell last June, I expressed concerns regarding the threat of insolvency at First Executive. I said the benefits of First Executive's 575,000 policyholders were endangered and the failure of First Executive could destabilize the entire life insurance industry.

Less than one year later, First Executive failed. Its failure demonstrates many of the flaws in the current system of insurance company regulation. Individuals who rely on First Executive for death benefits, annuity payments or pension benefits will be hurt. So will the well-managed conservative companies that may have to pick up the tab for First Executive'sexcesses.

Let me begin by describing my encounter with the California Insurance Division as the First Executive crisis began to unfold.

I. THE MINNESOTA EXPERIENCE, JANUARY 1990

I was appointed Commissioner of the Department of Commerce on January 9, 1990. As a new commissioner, I faced the following crisis environment:

In January, 1990, First Executive, the holding company for Executive Life Company of California and Executive Life of New York, announced a $515 million charge for bond losses. During the fourth quarter of 1989, First Executive reported an $835 million earnings loss. That loss was equal to roughly half of First Executive's capital surplus. Publicity regarding the company's level of junk bond holdings and its fourth quarter charge caused policyholders to dramatically increase their surrenders of the company's life and annuity products. During that same time period, Drexel Burnham & Lambert failed and the junk bond market, in which First Executive was 60 percent invested, declined some 9 to 12 percent.

In this crisis environment, I instructed my department to provide me with current information on First Executive's writings in Minnesota and its financial condition. Unfortunately, the information I needed was either unavailable or seriously dated.

The most recent onsite examination of Executive Life Insurance Company of California ("Executive Life"), the California domiciled life insurance subsidiary of First Executive, for year-end 1987 had not yet arrived from theCalifornia Insurance Division. The most recent A.M. Best ratingof Executive Life as of the fourth quarter of 1989, was A+.

Learning that we had no current information on Executive Life, I instructed my staff to inquire directly of the California Insurance Division for current information regarding Executive Life's liquidity, capital and surplus and Minnesota's exposure in the event of insolvency. While the California Department was under enormous pressure in late January as this crisis unfolded, the fact was that we could not obtain current information from them, despite repeated requests. We also disagreed with California's determination that neither a full scale examination nor a targeted exam of Executive Life was warranted. We pressed these alternatives because my department would have been allowed to participate in these examinations.

In essence, then, at a time when current information was vital, I lacked a current onsite examination, a current rating bureau report, or direct access to the company's books and records through a targeted or full examination. We were virtually without any current measure to monitor the company's deteriorating liquidity.

As the junk bond market continued to decline, I decided to act. On February 4, 1990, I sent Minnesota's chief insurance examiner and the department's life actuary to First Executive to monitor the solvency position of Executive Life. Specifically, I directed them to review the company's cash flow position, measuring it against surrenders, rollovers and withdrawals on life, annuity and deposit business. They also reviewed Minnesota premium and deposit volume to determine Minnesota exposure. During that examination, we obtained a copy, from the company, of the California Insurance Division's 1987 onsite examination of Executive Life.

As a result of this special examination, we required Executive Life to report to Minnesota, on a bi-daily basis, its surrenders and liquidity position. This direct information proved invaluable as we monitored Executive Life's situation throughout the first quarter of 1990. The National Association of Insurance Commissioners ("NAIC") played a positive role in this monitoring process. A NAIC working committee had been monitoring the First Executive situation for many months. This group became more active in February of 1990. My department insisted that the NAIC negotiate an arrangement with First Executive to protect policyholders in Minnesota. Basically, the arrangement required Executive Life to meet certain reporting requirements, agree to certain undertakings and to avoid preferences to California policyholders. In return, we agreed not to proceed on our own against First Executive and allowed California, as the domiciliary state, to play the leading role in directing the company's responses.

As a result of my experience with the California Insurance Division and my concern with the condition of the junk bond market, I again acted in February 1990. I required those 40 companies with the highest junk bond holdings as a percent of capital surplus to report the current market value of those junk bond holdings to the State of Minnesota. This report of market value was to be as of February 28, 1990. My concern was that there had been such a precipitous decline in the junk bond market during the first two months of 1990, that year-end financial statements would miss this substantial two month decline. We used this more current asset value information to determine whether immediate action might be necessary for any of these companies.

II. WHAT EXPLAINS OUR DEPARTMENT'S DIFFICULTY IN DEALING WITH THE CALIFORNIA INSURANCE DIVISION?

As the crisis developed at First Executive, the California Insurance Division became uncooperative; in our view, it withheld information on the company's condition. Why was this the case? It became clear to me that when a crisis develops in a state domiciled insurer, the interests of the local, state regulator quickly diverge from those interests of the other states.

I can really only speculate as to why the California Insurance Division became uncooperative. As you may know, California had no guaranty fund in place during the calendar year 1990. It was one of only six states that lacked this safety net for policyholders of failing companies. Unlike the other states where guaranty funds existed, California policyholders had no protection in the event a California domiciled company, like First Executive, failed.

No doubt the absence of a guaranty fund would have been embarrassing politically to the then current administration and legislators. Clearly, there were compelling political incentives to keep the company afloat during 1990. Also, during this year, the California legislature adopted guaranty fund legislation which went into effect January 1, 1991.

First Executive accumulated 60 percent of its investments in junk bonds. This was permitted because California had no limit on the percentage of a company's assets which could be invested in noninvestment-grade bonds. The absence of this limit allowed First Executive to embark on the high risk path of investing in junk bonds for their high yield without regard to the ultimate consequence for policyholders.

III. THE POTENTIAL IMPACT ON MINNESOTANS OF A FIRST EXECUTIVE FAILURE WILL BE SUBSTANTIAL

Recent reports by the Minnesota Commerce Department found that there are approximately 4,800 individuals covered by First Executive contracts or policies in Minnesota. As of January, 1990, Executive Life of California had sold approximately $250 million worth of policies, annuities or guaranteed investment contracts to Minnesota residents or entities. During 1990, approximately $100 million of the aforementioned amount was surrendered to the company leaving roughly $140 million of policies or contracts in place.

Because of recent actions by the California Insurance Division and due to coverage l imitations under state guaranty fund law, many Minnesotans may not receive benefits they anticipated under First Executive contracts:

1. Cash surrender values and loan options have been suspended.
2. Annuitants' monthly payments will be reduced by 30%.
3. Pension fund monies invested in GIC's will not be covered by the Company. Coverage under state guaranty laws differ from state to state, but there are substantial limitations.

IV. RECOMMENDATIONS

For these and other reasons, steps need to be taken to improve the current regulatory process.

I have recommended on a number of occasions that the insurance regulatory community be modeled more closely after the current bank regulatory model. As Commissioner of Commerce in Minnesota, I oversaw both bank and insurance examination divisions. Based on my observations of the workings of both the banking and insurance divisions, I have, at various times, recommended the following changes in the current insurance solvency monitoring process:

1. *More frequent examination of troubled companies.* Currently, all companies are examined on a triennial basis. While the timing of those examinations may need to be reconsidered, it is clear that regulators should spend more time with troubled companies and less time with well managed companies. Currant staffing limitations make it impossible for a state such as Minnesota to spend much time with troubled companies such as First Executive.
2. *Triennial examinations must be provided in a timely fashion.* Triennial examinations must be completed promptly and provided to other states on an expedited basis.
3. *Emphasis on credit analysis.* Bank examiners are capable of performing a detailed credit analysis on individual loans. This means, for example, in connection with a real estate loan, that an examiner will challenge the assumptions underlying an appraisal, make sure that financial statements on any guarantors are current, and determine that current operating cash flows from a property satisfy debt service

coverage ratios used for underwriting the loan. Insurance examiners generally do not perform similar indepth credit analyses on company real estate, loans and investments. The insurance regulatory community must develop this capability quickly.

4. *Risk rating of troubled loans.* These systems cause management to review all loans on a regular basis for credit quality problems. They also require that reserves be set aside for credit quality problems or potential loss. Insurance companies should adopt similar risk rating systems for their real estate and other loans.

5. *Market value accounting for distressed real estate.* For the most part, statutory accounting 1permits companies to carry real estate loans and investments at book value. With the substantial decline that has taken place in the value of commercial real estate investments over the past two years, I have advocated that statutory accounting techniques for distressed real estate be updated. My recommendation is that for commercial real estate investments or loans where there is clear evidence of distress (90 daydelinquency in payment of principal and interest, or in foreclosure, or current appraisal substantially below market, or owned real estate), statutory accounting should require these holdings to be carried at market value as determined by a current appraisal. This approach is similar to the reserving requirements under risk rating systems of many conservatively managed banks.

6. *Risk based capital requirements.* Bank regulators commonly measure the financial strength of a 1regulated institution by capital to asset or capital to risk adjusted asset ratios. These standard capital adequacy measuring tools are relatively new to the insurance industry. During my tenure as Commerce Commissioner, the Department of Commerce adopted a risk-based capital formula to be applied to all companies doing business in the state of Minnesota. It measures the adequacy of a company's surplus in terms of the risk in its investment portfolio, the adequacy of its reserving policy, the degree to which its assets and liabilities are properly matched, and the degree of interest rate risk in its assets and liabilities. I strongly recommend the use of such a solvency monitoring tool on a national basis.

V. THE NEED FOR UNIFORM, MINIMUM STANDARDS AND TOUGHER MONITORING CAPABILITY

First Executive is truly a disaster—for the annuitants and pension beneficiaries who may lose a portion of their retirement savings and for the well-managed companies who will pay dearly through state guaranty associations for First Executive's excesses. Companies in Minnesota estimate that Guaranty Fund assessments for First Executive losses could wipe out earnings for as many as three years. The policyholder loses either way—either because promised benefits are not received or because premiums increase as companies pass on the cost of Guaranty Fund assessments.

A regulatory process that allows different standards and solvency monitoring capability in each state can no longer be tolerated. This is the process that allowed First Executive to grow. The time has come for all states to enact tough and uniform solvency standards and to acquire minimal monitoring capabilities. The present lack of uniformity pulls the current 50 state regulatory process down to its lowest common denominator.

There are a number of areas where uniform, minimum standards will be necessary—investment laws, guaranty funds, reinsurance, accounting and reserving, managing general agents, monitoring capability. Uniform, minimum standards tied with tougher monitoring capability would have prevented the growth and demise of First Executive.

I am not arguing necessarily for federal regulation. There are many ways in which these standards could be adopted. One approach, obviously, is for you to develop these standards at the federal level and require states to adopt them. The problem with this approach is that you need the full participation and expertise of various groups (industry, regulators, consumers). To obtain that participation and to actually pass legislation may take years. The NAIC is working on solvency standards and monitoring accreditation. Ultimately, I believe they will develop a strong product—but it may not be soon enough.

A third approach involves a hybrid of the first two and is the one I have proposed to Congressman Dingell. Leaders of the House and Senate should form a task force of industry executives, 1regulators and representatives of consumer groups. The task force should be given a four to six month period to reach agreement on a uniform set of minimum standards for solvency monitoring.

This approach has worked in Minnesota. A group of ten CEO's and members of my department drafted a comprehensive reform of our state's solvency monitoring capability. This was done in only four months. The report will be enacted by the Minnesota legislature and includes the:

—toughest Junk Bond limit in the nation

—a risk-based capital formula for isolating troubled companies

—mark to market accounting and reserving for troubled real estate

—an industry commitment to pay for more department staff to improve the Department's solvency monitoring capability.

I advocate this approach, within a compressed timeframe, because I know firsthand that it works.

Senator BRYAN. Well, we greatly appreciate your testimony, Mr. Borman, and those suggestions. And we will have a few questions after we hear next from Mr. Sutton. Mr. Sutton, welcome to the hearing.

STATEMENT OF TOM SUTTON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF PACIFIC MUTUAL LIFE INSURANCE CO., ON BEHALF OF THE COUNCIL OF LIFE INSURANCE, WASHINGTON, DC

Mr. SUTTON. Thank you, Mr. Chairman. I am Tom Sutton, chairman and chief executive officer of Pacific Mutual Life Insurance Co., located in California. Setting aside Executive Life, I believe we are the largest life insurance company domiciled in California.

Accompanying me are Richard Minck, executive vice president of the American Council of Life Insurance, and Jack Blaine, ACLI retired general counsel and currently a consultant to ACLI. I appear today for the ACLI which I serve as a member of its board of directors and a member of its special taskforce on solvency concerns.

We are pleased that you have called these hearings to address the subject of solvency of the life insurance industry, and we appreciate the opportunity to present our views. It is in our interest as corporate citizens and as business executives to do everything that we can to enhance the solvency of the companies in the life insurance business.

As you have heard several times this afternoon, when a company becomes insolvent the rest of us pay the cost, not only in loss of consumer confidence, but in a more direct economic way. We have already seen the effects of underpriced products in the marketplace, where Executive Life was taking away the business of more prudently managed companies by illustrating or guaranteeing unrealistic interest rates.

One current example is that Pacific Mutual was one of the losing bidders on the Pacific Lumber annuity case that you just heard about. And in addition to lost clients, the industry now may be called upon to pay assessments levied by the various State guaranty associations. So, we believe that our ultimate objectives are the same as yours: to ensure a regulatory system that will minimize life insurance company failures, and thereby maximize protection of consumers from loss.

My company wants strong, effective solvency regulation. I know that I have the support of every responsible life insurance company executive in this goal. That is why the ACLI appointed its taskforce on solvency concerns in 1989. To quote from that taskforce report published last fall:

> We believe that no widespread deterioration in the solidity and solvency of the life insurance business exists. We acknowledge, however, that the general competitive climate and changing economic conditions affecting certain markets during the

past few years have forced life insurance companies to operate with smaller margins, and to accept somewhat higher levels of risk than in the past.

We also acknowledge that despite the overall financial stability of the industry, there are undoubtedly individual companies which have taken and will continue to take unreasonable risks. Steps must be taken to address the potential problems caused by those conditions.

We do not believe any fundamental change in the basic structure for regulating life insurance companies is necessary in order to address solvency concerns. We do believe, however, that the State regulatory system must be strengthened to keep pace with the more volatile economic environment in which insurers now operate.

Toward that end, our taskforce made 16 specific recommendations to improve State regulation, and ACLI is currently engaged in implementing them through our support for State legislative and regulatory initiatives.

These recommendations include tightened regulation of holding company transactions and reinsurance arrangements, expanded authority for early regulatory intervention against companies headed for trouble, and improved standards for insurance company examinations. Over 180 bills to improve solvency regulation have been introduced in the current State legislative sessions, and 36 have already been enacted.

Let me pose and suggest answers to four key questions. One, why was Executive Life allowed to take the actions which led to its demise? The first and foremost reason was the financial euphoria of the 1980's, centered around high-leveraged, high-debt instruments. I would refer to John Kenneth Galbraith's recent book "Financial Euphoria" as important background material.

The key fact is that many economists, many financial analysts, Wall Street, and many others were persuaded that these kinds of deals were innovative and relatively safe investments. I would like to take credit for my company and the great bulk of our industry for not being swept away by that euphoria. Our investments in low-grade securities have been modest in size, and they have been focused on solid, middle American companies, not leveraged buyouts.

Regarding Executive Life's strategy, Pacific Mutual and others in the industry have had a high level of concern which was dismissed by some regulators at that time as competitive sour grapes.

Second, Executive Life, together with others in the Milken daisy chain, had substantial lobbying power in Sacramento. For example, last year I testified in favor of a legislative limit on below-investment grade securities before the California assembly insurance and finance committee. Intense lobbying by those opposed to such a limit led to only 4 affirmative votes out of a committee of more than 20. Could we have done more at the time? Perhaps, but the combination of financial euphoria and political clout would have made success extremely difficult.

I would point out, especially in response or in reaction to some of the earlier comments about guaranty associations, that the industry in California did take the initiative to make sure that we did pass a guaranty association bill last year. I was personally involved in that, and while I am not a lawyer, I would want to tell you that the language that was used in that bill, in my mind, would fully apply to Executive Life. There was no intention on my part or even a thought that it would not apply to Executive Life. And I believe that position would be supported by the majority of members in the Association of California Life Insurance Companies.

Second question, Does this situation indicate a systemic failure of State regulation? No. Although the regulatory system did not prevent Executive Life from making investments that were too risky or in amounts that were too large, that problem highlighted areas where changes in laws and regulations were needed.

Necessary corrections have been identified, and the State insurance department, State legislators, and the life insurance industry are actively working to get these changes enacted. And the climate at this point I would say is very favorable for passage. These activities and the legislative efforts throughout the country are the signs of a healthy system, able to react to change constructively rather than of a system that is in failure.

Three, What actions have been taken to clear up the gaps in the existing regulatory system? I have mentioned some already. The NAIC's next president, Nebraska Commissioner McCartney, testified on Tuesday to the many specific steps that his organization is taking. We support the NAIC's solvency policing agenda and we are actively seeking enactment of laws in all 50 States to further enhance insolvency detection and prevention systems.

Those laws include tighter restrictions on an insurer's ability to concentrate an inordinately large share of assets in high-risk investments, and tighter controls on other areas of concern to the industry and to its regulators.

Four, What role should the Federal Government have at this time? The recent focus on this topic on the part of your committee and others in Congress has already had a positive effect in emphasizing the importance of prompt implementation of the corrective actions identified. We continue to believe that the State regulatory system will respond appropriately, and we urge that the system be given time to demonstrate that belief.

If the States fail to accomplish this goal, reexamination of the situation would clearly be required. However, consideration of Federal involvement other than oversight should proceed with great caution and deliberation so that we avoid any potential market and financial disruption in the industry, a disruption which could be severe and could have an adverse effect on millions of policy owners and investors.

Fortunately, as our written statement points out in detail, the investments of Executive Life are far different than those held by life insurers generally. The industry's assets are prudent investments that are widely diversified. We think the industry's overall good health will serve it well through current as well as future economic conditions. Those relatively few insurers that do not make it will trigger activation of the insurance guaranty system, and their policy owners will have a substantial safety net of protection.

ACLI supports State regulation of insurance. We feel that it has performed well, and that it compares favorably to other financial regulatory systems. It could be better, and we are working hard with a strong sense of urgency to make it better. Thank you.

[The prepared statement of Mr. Sutton follows:]

PREPARED STATEMENT OF THOMAS C. SUTTON

Mr. Chairman, members of the Committee, I am Thomas C. Sutton and I am chairman and chief executive officer of Pacific Mutual Life Insurance Company located In Newport Beach, California. I appear today on behalf of the American Council of Life Insurance where I serve as a member of the Board of Directors and as a member of its special Task Force on Solvency concerns.

The American Council of Life Insurance (ACLI) is the major national trade association of life insurance companies. It has a membership of 616 U.S. and Canadian life insurance companies which, in the aggregate, have approximately 94 percent of the life insurance in force in the United States.

We appreciate this opportunity to respond to the Committee's invitation to address the issue of solvency of the life insurance industry, and specifically the implications of the recent takeovers of Executive Life Insurance Company of a California and Executive Life Insurance Company of New York by their respective domiciliary state regulators. The Committee is concerned about the ultimate effect these actions may have on the policyholders and beneficiaries of these two companies. We share your concerns. At this time, we can only express the hope that the California and New York insurance regulatory officials will succeed in their efforts to rehabilitate these companies.

We must defer to the California Insurance Commissioner and New York Superintendent of Insurance for information on the financial condition of the Executive Life companies and on regulatory activities. The ACLI is not party to those official proceedings and does not have direct access to the records, results of special examinations or other confidential information about efforts to solve the problems these two companies face.

What is a matter of public record is the fact that these two companies were heavily invested in high risk corporate bonds, commonly referred to as "junk bonds." As the default rate of those obligations increased beginning in early 1990, these companies were faced with the compounding problem of increased withdrawals and a rapidly decreasing ability to meet the demands for cash. The combination led to their takeovers last month by the respective state insurance regulators.

One of the major points we hope to leave with the Committee today is that the Executive Life companies are not the precursors of a rash of failures in the life insurance industry. There are, undoubtedly, other life insurers that have engaged in similar imprudent activity and some of them may very well follow the same path. However, they are not indicative of the general health of the industry and the overwhelming majority of life insurance companies.

The Committee's concerns about the financial health of the life insurance industry are understandably intensified in light of these recent events. Our testimony, as well as other information provided in the course of these hearings by the state regulators and recognized professional insurance company rating agencies, should allay any concerns you may have regarding the financial condition of the life insurance industry. We do recognize that industry trends and aggregates can and do obscure the performance of individual companies. In fact, no industry as competitive or as large and diverse as ours will be without its occasional failures.

Since our products provide long-term financial protection and security for millions of American families, we understand the concerns and agree that everything possible should be done to spot potential future problem areas for our business. We need to ensure that the life insurance business is able to fulfill its promises in bad as well as good economic times. What we intend to show by the following testimony is (1) that the industry has a financially strong base; (2) a regulatory structure is in place which has a good record of solvency regulation and is in, the process of being strengthened; and (3) that the state insurance guaranty association mechanism operates as a safety net to protect the consumers of our products. We address each of these three areas in the following statement.

SOLIDITY OF THE LIFE INSURANCE INDUSTRY

The measurement of the financial strength of any insurance enterprise involves analysis of both sides of the financial statement: assets and liabilities. Inadequacy of life insurance companies' reserves has rarely been a cause of insolvency. In some cases, life insurance company insolvencies have been caused by inadequate premium rates for health insurance or other lines. However, the focus of attention on life insurers has always been on the quality of the assets. This was true even before the recent concerns about junk bonds and commercial real estate. Incidental to that concern is insurer liquidity, i.e., the ability to match current demands with available assets. Liquidity, or asset/liability matching became especially important to management in the late 1970's with the shift of business into interest sensitive products.

An insurer may have adequate assets in its annual financial statement to meet future liabilities, but it might not be able to meet cash demands in the form of policy surrenders or withdrawals if its assets are not sufficiently liquid or if current market values are depressed. This may result in a classic "run on the bank" as evidenced by Executive Life.

The insurance regulators, professional organizations of actuaries and the ACLI have all given" a great deal of attention to finding regulatory solutions to the problem of matching assets to liabilities. Last December, the NAIC, after several years of work, adopted a requirement of an actuarial opinion on each life insurer's ability to meet cash flow demands. This new requirement, commonly known as the valuation actuary statement, has the support of the ACLI. It will impose a recognized management discipline uniformly on all but the smallest life insurers. As pointed out later in this statement, life insurers' investment practices have already changed to effect a matching of assets and liabilities.

LIFE INSURANCE INDUSTRY CAPITAL AND ASSET BASE

The financial strength of the life insurance business reflects both the quality of its assets and the integrity of its investment practices. Investment managers generally agree that the fixed-income bonds and mortgages purchased by life insurance companies are very conservative investments. Usually, life insurance commercial mortgages are not made until properties are producing a steady stream of income. Both mortgage borrowers and bond issuers are contractually obligated to make periodic payments to life insurance companies which help to provide needed liquidity.

The investment portfolio of the life insurance business is and has been primarily in fixed-income securities and mortgages which generate a steady cash flow. For example, total corporate and government bonds as a percent of total general account assets has not been less than 41 percent throughout the postwar period and stood at 58 percent at the end of 1989. Total investment in bonds plus mortgages was 87 percent of general account assets in 1950 and 80 percent on January 1, 1990. Real estate holdings over the years have been less than 5 percent of general account assets. Investment in common and preferred stocks as a share of assets has never been higher than 7 percent in the last 45 years and was 5 percent at the end of 1989. The common stock share stood at only 4.3 percent at the end of 1989. Commercial mortgages, which are backed by income-producing properties, comprise 92 percent of total mortgage holdings at year-end 1990.

The industry's investments are well diversified with very small exposure to the volatility of the stock market. Commercial mortgages are diversified across U.S. regions and types of properties. The bond portfolios are diversified among government obligations, foreign government bonds and corporate bonds. Corporate bonds are also diversified, not only among companies and industries, but also by maturities.

Quality of Bond Investments of Life Insurance Companies. The National Association of Insurance Commissioners (NAIC) Securities Valuation Office (SVO) categorizes, by credit quality, all public and privately-placed bonds held by life insurance companies. The NAIC rating system is based on assessments made by the staff of the SVO. Their quality designations take into account corresponding ratings by public bond rating agencies when they are available, the borrower's financial ratios as well as collateral and protective covenants of the debt instruments. Included among the highest quality bond category are debt issues of the federal government and those carrying a U.S. government guarantee and thus are free of credit risk (7-8 percent of general account assets). The SVO in 1990 took steps to substantially tighten its oversight of bond quality and of security valuation reserves against defaults.

Through December 31, 1989, bonds had been classified by the NAIC Securities Valuation Office into four categories for the purpose of determining the appropriate reserve to be set aside in an asset reserve called the Mandatory Securities Reserve (MSVR).[1] The new standards established in 1990 refined this to six categories. The increase was accomplished by dividing the old "Yes" category (which required a reserve equal to 2% of the value of the bonds) into a new Category 1 with a 1 percent reserve, Category 2 to continue with a 2 percent reserve, and Category 3 to have a 5 percent reserve. The periods allowed for reserves to build up to the maximums were shortened. In this way the reserve standards for bondholdings were substantially tightened.

The NAIC instructed the SVO to recategorize all public and private bond issues into the six new categories before year-end 1990. In this process, some bonds migrated downward in rating category; some migrated upward from where they had been at the end of 1989. The following table, compiled from a preliminary ACLI special survey of 100 large companies, estimates how bondholdings were distributed among the six categories as of December 31, 1990. Actual aggregates of all holdings reported in 1990 annual statements are not yet available at this time (May 9, 1991).

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[1] The MSVR is required of life insurers by statutory accounting rules to buffer surplus from fluctuations in stock and bond values.

ACLI Preliminary Bond Quality Distribution Survey, General Account Portfolio, December 31, 1990

[Percent]

1990 quality rating per NAIC	Publicly traded bonds	Private placements	All bonds
1	77.5	41.6	64.8
2	16.7	38.8	24.3
3	2.2	10.2	5.0
4	2.8	5.7	4.0
5	0.6	2.5	1.3
6	0.2	1.2	0.6
Total	100.0	100.0	100.0

The six categories approximate a continuum of credit quality from highest to lowest. Among the six NAIC categories, Categories 1 and 2 are viewed by the SVO as higher grade; Category 3 is viewed as medium grade; and Categories 4, 5 and 6 are seen as lower grade in terms of credit quality. As shown in the table, most of the lower grade bonds held by life insurance companies at the end of 1990 were private placements. Only 3.6 percent of the public bonds held by life companies were lower grade. This is because life companies have generally invested conservatively and most companies have not been in the market for the public bonds used to finance leveraged buyouts (almost all of which were issued in the 1980s).

For a century, life companies have profitably been making private placement loans to companies not large enough to get the highest public bond ratings from the credit rating agencies. The yield on these private placements has been greater than higher quality public corporate bonds so as to compensate lenders for the additional risk or lower liquidity. Yet private placement bonds have more protection against credit risk than their higher yield would indicate. Private placement bonds normally are better collateralized than public bonds of similar grade; they have stronger covenants protecting lender interests; and they have provided greater recovery of assets for lenders after default than have public bonds. Private placement lending by life insurance companies has long been a major source of long-term financing for second-tier corporations (i.e., those not large enough to use the higher grade public corporate bond market). Less than ten percent of all U.S. corporations can issue bonds that will be classified as investment grade. This means that restricting life insurance company investments to investment grade bonds would seriously damage the availability of credit for the remaining 90% of corporations.

Reported statistics on the quality of bonds in life company portfolios often overlook the fact that almost all bonds held by the vast majority of life insurance companies are in good standing. That is, they are paying interest as agreed. When they fall behind 60 days or more in payments, they are "in default." In the years from 1978 through 1989, the bond default rate as a percent of general account assets went above one-fourth of one percent of the general account only twice (.26% in 1983; .28% in 1987). A reasonable level of holdings of medium and lower grade direct placements and public bonds should not be of concern since it is the credit quality of the total bond portfolio, not a small segment of that portfolio, that is most relevant to financial strength measurement. Also, in any solvency threat, all the assets of the general account and company surplus stand behind insurance company guarantees to policyholders and annuitants.

Real Estate-Backed Investments of Life Insurance Companies. Because the liabilities of life insurance companies are intermediate to long term in duration, investments too can appropriately be intermediate to long term. Thus, mortgage loans have long been a major investment category of companies in this industry. Over 90 percent of the mortgage loans made by life insurance companies are for commercial properties--apartments, shopping centers, office buildings, and industrial buildings.

There are several kinds of real estate loans, some much riskier than others. For example, short-term loans are made to acquire undeveloped land, to develop it, and to construct buildings. Life insurance companies are typically not involved in these types of lending.

As the buildings are completed, short-term construction loans are paid off when long-term mortgage loans are made. This is the phase in which life insurance company lending comes in. Mortgage loans by life companies usually are not made until a building is nearly leased up with tenants or when the borrower has received third-party income enhancements or credit support. Loans are usually not made for more than 75 percent of a building's value. Lenders most often require that net monthly income on the property will be larger than the cost of servicing the mortgage debt by 20 percent or more.

Life insurance mortgage loans are also protected by broad diversification over types of properties and across national regions. This diversification often means that declines or increases in one sector or region are at least partially offset by an opposite trend in other sectors. Classifying mortgages by types of buildings, the largest holdings share is in office building mortgages (40.4%) and the smallest share is in hotel/motel mortgages (4.9%). Classifying by regional share, largest is the Pacific with 21.8% of mortgages held; next is the South Atlantic region with 20.5%. Smaller regional holdings are in the New England states (6.6%), West North Central (4.8%) and Mountain (4.2%).

Delinquency rates on agricultural mortgages have been falling since mid-1986, and commercial mortgage delinquency rates have also been improving in the hard hit Mountain and West South Central states. The national trend of mortgage delinquency rates, however, rose in 1990. This is mainly the result of sharp increases in delinquency rates in the New England and Atlantic regions.

Under present real estate conditions, the annual rate of completed foreclosures was 1.42 percent of all mortgages for 1990. Prior to foreclosing on a property, companies make every effort to restructure a mortgage loan to make it work out. That cannot always be done, and sometimes life insurers are left with no other alternative but to foreclose. Because of their other assets, robust cash flow, and long-term liabilities, life companies do not have to make distressed sales of properties on which they have to foreclose. If the company can see that business or real estate value cycles are likely to improve or a property is otherwise currently undervalued, they are able to hold the property and if necessary improve it for later sale.

The life insurance industry holds about 25 percent of all outstanding commercial mortgages, less than the share held by commercial banks. The top 30 life companies hold most of this. Mortgages as a percent of life insurance industry general account assets fell from 29 percent in 1980 to 22 percent in 1989. Over the same period, commercial banks increased their asset share of mortgage lending.

Foreclosed property owned is not excessive in this industry. For perspective, in assessing the size of the problem in life insurance, the thrift industry's Resolution Trust Corporation had $16.4 billion in foreclosed properties to dispose of at year-end 1989. All insured savings associations reportedly had $40.6 billion in repossessed assets and real estate held at the end of 1989. The commercial banks held $12.5 billion in "other real estate owned" at the end of 1989. In contrast, at year-end 1989 the life insurance industry held only $6.3 billion in "real estate acquired in satisfaction of debt," one-half of one percent of general account assets.

Neither the 1990 downturn in the non-investment-grade bond market or the slump in real estate markets has 'noticeably impaired the financial strength of the insurance industry. The industry has repeatedly shown its resilience in managing economic dislocation. Before the relatively minor stresses of 1990, the most recent macroeconomic problem imposed on the business was the high inflation followed by deep economic recession in the late 1970s and early 1980s.

MANAGING MATURITIES OF ASSETS AND LIABILITIES

Life insurance companies have been aggressive in moving to improve duration matching of assets and liabilities. This can be seen in the shortened maturities in their bond and mortgage portfolios in the early 1980s. Bond acquisitions in over 10-year maturities fell from 85 percent of acquisitions in 1980 to 53 percent in 1983 and 48 percent in 1989. Similarly, the over 10-year share of mortgage acquisitions fell from 95 percent in 1980 to 48 percent in 1983 and 19 percent in 1989. This enabled companies to, better match the maturities of their assets with maturities of their liabilities. The result is better management of the higher risks inherent in volatile market interest rate movements.

PROFITABILITY

After some years of declining profitability, in 1988 and 1989 life insurance companies began what appears to be a turnaround. On May 29, 1990, A.M. Best's Insurance Management Reports reported that, "For the second consecutive year the life/health industry's statutory operating performance improved significantly in 1989 due in part to lower premium growth, greater cost containment measures and better persistency. The U.S. life/health industry's net operating gain increased 30 percent from the prior year-end results--the same percentage growth as in 1988. The industry posted a 13.6 percent return on equity in 1989, compared with 11.7 percent in 1988.

More than one rating service has concluded that, having come through the past decade in an environment of heightened competition and increased risk in their product lines, many insurers are changing their emphasis from growth to profitability. This is perhaps the most important argument in support of the great financial strength of this business, the adaptability to changing conditions. Financial strength can trend downward for a period of time, but there are self-correcting forces which lead companies to reduce costs, discard unprofitable business lines, retard capital-using asset growth, improve product pricing, and take other optional steps to strengthen their financial position.

ACLI SUPPORT FOR STATE EFFORTS TO IMPROVE SOLVENCY REGULATION

The ACLI has long been vigilant about solvency of life insurers. Board level task forces have been appointed to study solvency regulatory measures and the guaranty fund system in the mid-1970's, again in 1985 following the failures of the Baldwin-United insurance companies and most recently last year. The ACLI Task Force on Solvency Concerns concluded last year that there had been no widespread deterioration in the solidity and solvency of the life insurance business taken as a whole. However, they noted that a few companies had taken some risks that put them in some danger. Finally, the Task Force also urged that the state regulatory system be strengthened to keep pace with the more volatile economic environment in which insurers now operate. The Task Force recommended ACLI support adoption in every state of a specific list of Model Laws and Model Regulations, as well as other actions to strengthen state regulation.

ACLI also strongly supports the NAIC's Financial Regulation Standards and Accreditation Program. This program, which has been described more fully in earlier testimony by the NAIC, encompasses the NAIC's establishment of regulatory standards in the form of specified model laws and model regulations, plus subjective standards relating to personnel and other regulatory resources. If, after review by a team of independent examiners, the state is found to meet the standards, the NAIC will certify that state as being in compliance.

The NAIC's Financial Regulation Standards program provides a mechanism both for the encouragement of improvements in state regulation as well as some compulsion for individual states to achieve a higher level of regulatory standards. More important is the concentrated effort that has been achieved through the cooperative support of the NAIC, the individual state legislators and regulators, and the insurance industry.

The life insurance industry, through ACLI and its member companies, has a vital stake in minimizing insolvencies. To the extent that company failures exceed the norms expected in any competitive industry the public's confidence in the life insurance industry is undermined. In addition, losses due to insolvencies are paid for by the rest of the industry through assessments levied by the state insolvency guaranty funds. When insolvencies were rare and relatively small in financial impact, the life insurance industry and the public could tolerate them. As the number has increased in the last ten years and the potential for failures of companies the size of Executive Life have been widely publicized, the public and the industry's tolerance level is naturally strained. ACLI, therefore, has a real interest in seeing better solvency regulatory controls adopted and enforced. We are making every effort to obtain enactment of essential laws and the adoption of other critical solvency regulatory measures.

By way of illustration, the ACLI Task Force recommended support for specific action in the critical areas of audited annual financial reports; tightened regulation of reinsurance; participation by all states and all insurers in the NAIC Insurance Regulatory Information System; stricter oversight of transactions between affiliated companies in an insurance holding company system; expanded authority for regulatory officials to take action against companies headed for trouble, and better standards for insurance company examinations. ACLI and its member companies are supporting legislation this year to enact these and others measures to strengthen regulation for solvency in some 37 state legislatures. Over 180 bills have been introduced, 36 have already become law.

ACLI's commitment to continued state regulation of insurance is based on the analysis our Task Force and Board of Directors have made of the ability of the current system to do an effective job. We have concluded that the record of the states' success in regulating life insurance has been quite good relative to other regulated industries. As one measure of its success, we note the relatively few insolvencies that have occurred in the life insurance business in the last decade and the relatively small amounts involved. During this period, 134 life insurance companies became impaired or insolvent and state guaranty funds contributed $474 million to provide benefits to policyholders. These amounts are much less than the losses from insolvencies of other financial institutions during the period. The attached charts illustrate both the numbers of failures of various financial institutions and the comparative costs.

The life insurance industry does not take lightly the Executive Life situation. We all hope that the regulators can work this situation out so that life insurance policyholders are protected and annuitants receive promised benefits from the companies. Even if they cannot and if the various state guaranty funds are called upon to take action for the benefit of policyholders, the problems of Executive Life should not be viewed as a symptom of trouble throughout the entire industry.

LIFE INSURANCE INSOLVENCY GUARANTY LAWS

Nearly all states have enacted a system for providing protection to policyholders and beneficiaries of insolvent life insurance companies. These laws are based on the NAIC Model Life and Health Insurance Guaranty Association Act adopted in 1970. The concept actually dates to 1941, however, when New York first enacted a law to create a guaranty corporation to provide protection for policyholders of insolvent life insurance companies.

The life insurance guaranty system differs in at least two major substantive respects from deposit insurance provided by the Federal Deposit Insurance Corporation for insured banks. The life insurance guaranty system is based on the laws enacted by each state rather than as a single federal law. Funds to provide benefits are raised on a post-insolvency basis, unlike FDIC which is funded in advance of insolvency through premiums charged to insured depository institutions.

There is another very important distinction: unlike the savings and loan and banking industries, life insurance has no ultimate recourse to the full faith and credit of the United States. Thus, life insurance company insolvencies become the sole obligation of the life insurance industry and its policyholders and stockholders, except to the extent that states allow a partial recovery through offsets against future state premium taxes.

currently, 47 states and Puerto Rico have life, health and annuity insurance guaranty associations. Legislation to create a guaranty association in Colorado was passed by the state legislative on April 23 and is currently on the Governor's desk for signature. Bills to create life and health insurance guaranty associations are currently pending before the legislatures of Louisiana and New Jersey, and before the City Council of the Distract of Columbia.

The original NAIC Model Act has been amended in several respects since its original adoption in 1970. Many of the amendments were clarifying or technical in nature, but in the late 1980's several substantive changes were made. One of these relates to the products covered by the Model Act and the limitations on such coverage, a reflection of the changing nature of the business since 1970.

A substantive change in the insurance guaranty law structure in the mid-1980's was a change to resident only coverage. The original NAIC Model Act was patterned after the 1941 New York law in following the concept of covering all policyholders of an insolvent domestic insurer wherever they reside. This was a practical approach at the time since virtually all life insurance company insolvencies had been disposed of through assumption reinsurance arrangements, with rarely any losses to policyholders or beneficiaries. There were other reasons of simplicity and practicality which led to that approach.

More recent insolvencies, including the Baldwin-United companies, revealed a problem in having a sufficient assessment base of premiums if only one smaller state was responsible for covering all of an insolvent insurer's obligations. The approach was therefore changed in the latest version of the Model Act to provide that the guaranty association in each state where the insolvent insurer does business will cover the policyholders and beneficiaries resident in the respective states.

The result of going to a residents only approach is to increase substantially the base for assessments in a multi-state insolvency. All but thirteen of the states with guaranty funds have passed legislation incorporating the residents only approach.

The insolvency guaranty system was never intended to guarantee payment of every policyholder's claim. As in the case of FDIC, or the coverage which is provided to defined benefit plan participants by the Pension Benefit Guaranty Corporation, there must be reasonable limitations on benefits and coverage to make the system economically feasible. The model law basic limits are $300,000 in life insurance death benefits, $100,000 in cash surrender or withdrawal values; $100,000 in health insurance benefits; and $100,000 in present value of annuity benefits, including cash surrender and withdrawal values. The overall cap for any one individual is $300,000. Although there are some variations, these limits are the prevailing ones in the various states.

When the Model Act was adopted in 1970, individual annuities did not constitute a major market; pension products were a much smaller line of business than they currently are. As the business changed and new products were introduced in the late 1970's and 1980's, questions arose regarding their coverage of new products under the guaranty laws. Variable annuities and variable life insurance, which are subject to securities' law jurisdiction and the disclosures appropriate to such products, are protected only to the extent that the insurer has guaranteed certain elements, such as minimum death benefits. The underlying fund values, which are dependent on the investment results, are not covered.

The Executive Life situation has raised questions about coverage of guaranteed investment contracts (GICs) under the state guaranty laws. These products, frequently sold by life insurance companies to pension plan trustees, could be covered as "unallocated annuities" in the NAIC Model Act if they meet the other conditions specified in the Model Act.

Annuities are covered by all of the existing 48 life and health guaranty associations (although some exclude particular types of annuities). Whether unallocated annuities are covered under various state guaranty association laws may not always be clear. Unless the state law specifically refers to unallocated annuities, the question of coverage may be answerable only by an interpretation by the courts of the state's law.[2]

Under the NAIC Life and Health Insurance Guaranty Association Model Act, unallocated annuities are covered up to $5 million in benefits per contract holder, irrespective of the number of contracts held by that contract holder. Unallocated annuity contracts issued to a governmental retirement plan established under Section 401(k), 403(b), or 457 of the Internal Revenue Code are covered up to $100,000 in present value of annuity benefits with respect to each individual participating in the plan.

The ACLI opposed the decision to include coverage of unallocated annuities in the NAIC Model Act for many of the same reasons ACLI opposes "pass through" coverage under FDIC for pension plan participants when the plan trustee purchases a bank investment contract. Pension plan trustees frequently make numerous investment decisions and they should know the companies with whom they are doing business. The state guarantee funds were intended to provide coverage to individual buyers for reasonable amounts. They were not intended to cover investments by pension plan trustees of millions of dollars. If such coverage were provided, it would not only relieve the trustee of the responsibility for prudent investment judgment, it would make it possible for insurers with neither the needed capital nor the appropriate experience to participate in that volatile market.

SUMMARY/CONCLUSION

The life insurance industry is in good financial health, and all but a relatively few companies are able to withstand the stress of the current economy and current problems in financial markets. However, history tells us that there will continue to be some insolvencies of life insurance companies. No regulatory system is capable of eliminating that threat completely. The record of State regulation of insurance is good in comparison to other financial industry regulatory systems. Improvements are needed in many states, however, and the insurance industry is motivated to support stronger regulation. A strengthened, responsive state regulatory structure is evolving from these efforts. Finally, the safety net provided by state insurance guaranty laws is in place as the few remaining states without insolvency guaranty protection consider enabling legislation.

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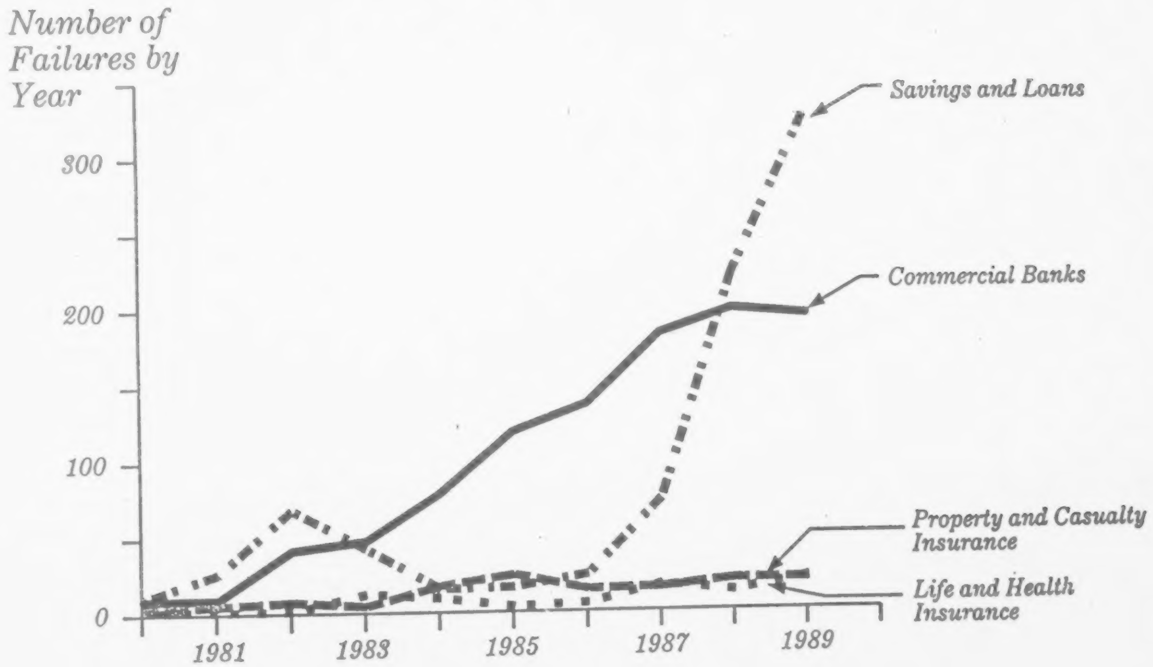
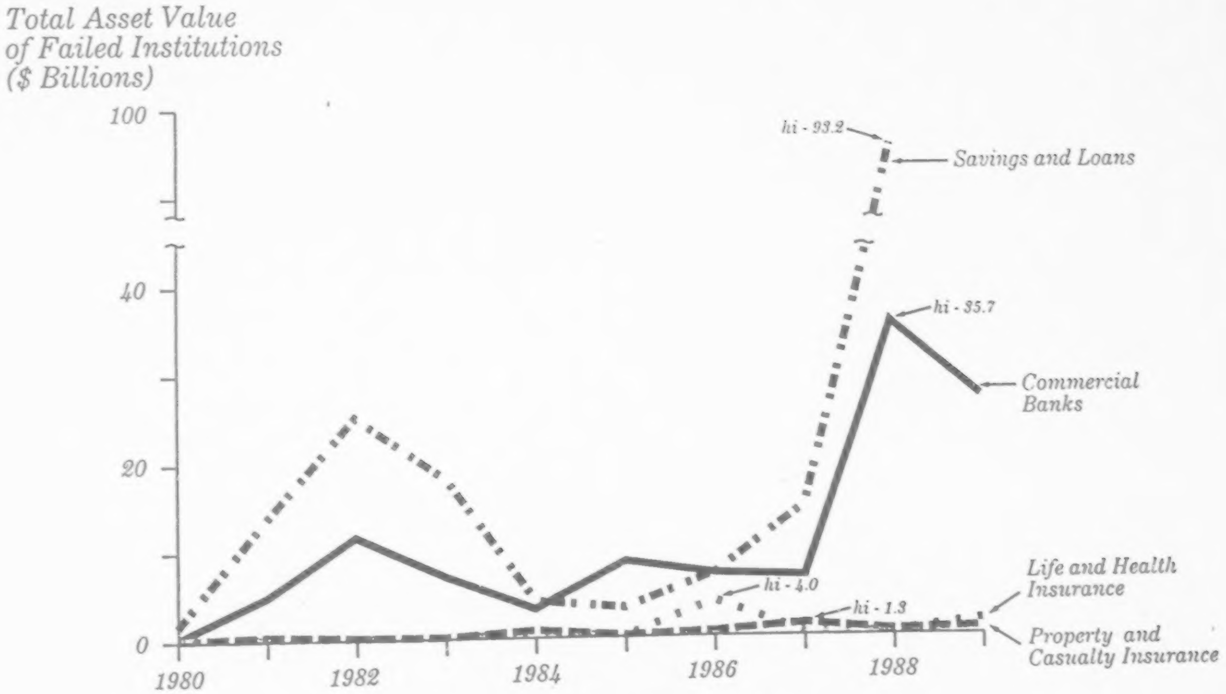
[2] Seven states specifically exclude unallocated annuities from guaranty association coverage: California, Hawaii, Kansas, Kentucky, Missouri, South Dakota and Wyoming. The Georgia guaranty association excludes particular types of unallocated annuities from coverage. The Tennessee guaranty association excludes unallocated annuities from coverage but covers 403(b) annuities. Idaho enacted a law this year that eliminates guaranty association coverage for unallocated annuities as of July 1, 1991. The new Colorado life/health insurance guaranty association legislation, now on the Governor's desk for signature, also excludes unallocated annuities.

Rising Tide of Failures



Sources: FDIC Federal Home Loan Bank Board IDS Financial Services, Inc. Insurance Services Office

Insurer Failures Small in Comparison to Depository Institutions



Sources: NOLHGA FDIC Federal Home Loan Bank Insurance Services Office

Senator **BRYAN**. Thank you very much, Mr. Sutton. Let me just make an observation and then we will go to the questions. In the context of these hearings, many have tried to frame the issue as to whether or not Federal as opposed to State regulation is a preferable option. I am not sure that is the purpose of the hearing. That is not where this chairman is coming from.

But really, the question is what can we do to prevent a recurrence of what all would acknowledge is a catastrophic impact upon 300,000 people who are innocent victims of what I believe is a failure in the system. Mr. Washburn makes the observation that some believe that only regulation in Washington can be effective. I do not happen to share that view either, Mr. Washburn. I do not think that is, certainly the savings and loan industry would be an example, and some would even point to the banking industry as an example of Federal failure.

Mr. Borman makes an interesting comment that perhaps there is a role for some national minimal standard, not necessarily preempting the States, but to make something uniform. So, put in that broad context, let me address the fundamental question that you raised, Mr. Sutton. You say that you believe that the Executive Life failure is isolated, it is a product of an environment of the 1980's. I think a lot of can agree with that. Hopefully, we will not see a recurrence of that. But I think we can all agree.

Let me ask you if you agree with an observation made by IDS in a financial position paper of March 1990, entitled "Will the U.S. Life Insurance Industry Keep Its Promises as Solvency Issues of the 1990's?" And it goes on to conclude, and I just would like to get your response to this if I may, we believe referring to IDS, there is a significant risk that one-fifth or 20 percent of today's major life insurers will become insolvent should there be a severe economic downturn or decline in the major investment markets.

Is that an overstatement from your perspective? And if it is, would you put this in some context for us?

Mr. **SUTTON**. I think it is an overstatement in terms of the impact on a listener. I am an actuary accustomed to talking in probabilities, and I think that statement was made in the context of probabilities. Obviously you can define scenarios that are so severe that it is possible to conceive of 20 percent of the companies in any grouping becoming insolvent.

You can also conceive of scenarios, economic scenarios that are so severe that most American companies and the American Government would essentially be bankrupt. I think that the impression given by the IDS statement is far greater than the substance actually should be. I believe that it would take an extraordinary cataclysm to come anywhere near having an effect of that sort.

In my view, the problem in the industry economically is relatively weak earnings compared to what they were 10 years ago. I do not believe that there is any systemic issue regarding insolvency of substantial numbers of companies or significant numbers of large companies.

Senator **BRYAN**. Are we likely, Mr. Sutton, to see other insurance company failures, life insurance company failures?

Mr. **SUTTON**. Yes.

Senator BRYAN. You think so. And can you tell us how widespread that is likely to be? Because although some have tried to say, "Well, you know, the Congress is just trying to get itself involved in another area." When you see this kind of a report and other comments which are made in financial journals, not by those who hold public office, and you look back over the decade—and I must say I consider myself very lucky, I was not here in Washington in the 1980's. I was very fortunate from my perspective.

I must say that there is kind of this blurred impression that in the 1980's, folks from the savings and loan industry were saying, "Hey, there is some isolated problems, no need to get involved." We all know how that story came out. A year ago, I happened to serve on the Banking Committee as well. We were told, look, that that fund is fine, that we are not going to need any Federal bailout.

Today I attended a hearing in which representatives of the industry, the independent banking association, the ABA, the major trade associations, if you were lining up, you know, a $10 billion-plus loan to in effect recapitalize the system. That ultimately, as you well know, Mr. Sutton, means you and I, the taxpayers, all of us collectively. And so when we hear these assurances it is not that we impugn your integrity, but I must say that there is a hope that you are right—because that is the last thing the country needs or this Congress needs to deal with.

But give us a little bit more of your sense. How widespread is the problem out there? And what levels of failure are we likely to see under the reasonable parameters, as opposed to the most Draconian, you know, a complete economic collapse?

Mr. SUTTON. Mr. Chairman, first, I sympathize with you and I feel the credibility issue that you raise. We have heard statements of consolation, let us say, from a variety of financial institutions that have proven to be ill-founded. So, I am sensitive to that issue.

All I can tell you is what I believe as, I think, a knowledgeable observer and participant in the industry. And I am telling you that I believe that among large companies—and let us say that means companies over $5 billion of assets—there may be one, maybe two, conceivably, more insolvencies. And I certainly do not want to name names at this point, but I think the companies are fairly well identified.

Senator BRYAN. No, I am not asking you that. We could get everybody energized to report to their local agent pretty quickly, but particularly on the west coast this time.

Mr. SUTTON. Now, as for companies under that size, first I would point out that if you look at the history, most of the insolvencies that have occurred have been quite small companies. I believe over the last 10 years, the average size of companies becoming insolvent is well under $100 million; $20 million if I remember right, but Mr. Minck may correct me.

Therefore, insolvencies generally involve very small companies, and usually those companies have become bankrupt as a result of fraud or inappropriate transactions among affiliated companies. Often they have been associated with group health insurance. So, I continue to believe that there will be a number of those kinds of insolvencies. But they will be, in terms of impact on the industry and on buyers in general, relatively small.

Senator **BRYAN**. Could you quantify it? Admittedly that is a difficult thing, but you have given us the breakdown of $5 billion as the threshold between large and small. I am accepting your characterization, although I suspect that most people in my State would think of a company that has $4.5 billion as being rather large. But I understand we are all talking about relative size, as opposed to absolutes.

What kind of trouble and what number, if you can quantify, are we likely to see on those companies that would be below the $5 billion? Can you give us again just a sense?

Mr. **SUTTON**. I will take a shot at it, and I would like Dick Minck to respond as well.

Senator **BRYAN**. And we appreciate your candor, by the way.

Mr. **SUTTON**. As I recall from looking at the past again, which is something that actuaries tend to do in order to make guesses about the future, I believe that the number of insolvencies has been well under 1 percent. I would believe that over the next several years that that would be the top end of an order of magnitude in terms of number of small companies.

Senator **BRYAN**. And how much, for those of us that did not excel in math and do not know, there are two factors as I recall that we need to crank into the equation before we know what the number is. And you have provided one. And by all means, defer to the gentleman there to your left if he has it. How many companies would that be, assuming Mr. Sutton is correct?

Mr. **MINCK**. It would be in the neighborhood of 15 to 20 a year.

Senator **BRYAN**. Fifteen to 20, all right. So, we are talking about 15 to 20 small companies by life insurance size, and the large ones, one, possibly two, Mr. Sutton, as I understood your testimony. Is that, I want to be fair to you——

Mr. **SUTTON**. My hypothesis on that subject did not mean one or two a year. It meant one or two at any time in the foreseeable future.

Senator **BRYAN**. And I appreciate your correcting the record, or at least clarifying the record on that.

Mr. **MINCK**. Excuse me, sir, I think it might be fair to say that these are possibilities and we have no very strong feeling that in fact they will occur.

Senator **BRYAN**. I understand. But you are trying to give us a little bit of the sense of the risk that lays out there. And I understand that these are not predictions or forecasts, but you are indicating that is the exposure.

In other words, that reasonable and prudent man that we all talk about, you are saying that the reasonable and prudent man or woman might anticipate reasonably, if economic circumstances do not improve, that we may see one or two failures of the large companies—underscore the word "may," not that we are predicting it—and may see as many as 15 to 20 in the so-called smaller companies.

Is that a fair characterization, so that our record is clear and that I do not misstate your testimony, because I want to be very fair about that.

Mr. **MINCK**. Yes, I think that is certainly fair. One other qualification that perhaps would be fair for the record. Whenever small companies get into trouble, lots of different things happen to them. In some cases they are acquired. They just disappear and go out of business. In some cases they are rehabilitated, and then in other cases they will in fact become insolvent.

And when I gave you a number of 15 to 20 or so that would not include perhaps an equal number that would be in some sort of difficulty, but not necessarily end up in insolvency.

Senator BRYAN. Now, Mr. Sutton, with the present structure of the guaranty associations, which obviously your cotestifiers to the right know a good deal about based upon their own experience. Let us talk about the small companies. Any serious problem at all in terms of the ability, assuming insolvency now, or whatever the trigger is, hazardous, impaired, or insolvent. I do not know what the words of art are, you fellows know that better than I do.

But should we have any serious concern about the ability of the guaranty associations to essentially protect those policyholders in the smaller companies in terms of the ability of the system, the guaranty association system, to handle that?

Mr. SUTTON. I do not believe so, Mr. Chairman. And while, again, Mr. Minck may correct my recollection of this statistic, my understanding, looking at the last several years in terms of guaranty fund assessments, is that the amount of the assessments has been something like 4 percent of the capacity of the system, which is a very small percentage of the capacity of the system.

So, even in the scenario that we just outlined, in terms of numbers of small companies and the possibility of a larger company, I believe that the capacity of the guaranty system would not be exceeded by a long shot.

Senator BRYAN. Now, let us get to that, the ionosphere, if you would, for the moment, the large, the one or two, the ones that are $5 billion and larger. What would be the impact, assuming that would happen—not predicting, and I want to be clear on the record that you are not forecasting this—but assuming that would happen, what is the impact on the policyholders of companies of that size?

Mr. SUTTON. Well, we do not have to project to a possible future difficulty among large companies. We can look at Executive Life. The situation is always very fuzzy without a great deal of background knowledge as to what the value of the assets is in their case, and how it matches up against the liabilities.

So, what I am saying is that we do not really know what the magnitude of the assessments to a guaranty fund would be. I would speculate that the outside limit of the assessments might be something like $1 billion at most.

Now, I do not know how that would be spread State by State. That would have an influence on the time it would take to make those payments, to be able to raise those assessments. However, as you recall from the testimony earlier, I believe the annual assessment capacity for all the guaranty associations together is something in the neighborhood of $3 billion.

Mr. MINCK. That is pretty close to what has been tabulated. And another key point of course——

Senator BRYAN. For the record, if we might get your name.

Mr. **MINCK**. I am sorry, it is Richard Minck of the American Council of Life Insurance. Forgive me, sir. The thing about it is that the process of taking care of people who have losses when a life insurance company goes under is quite different from property and casualty and other types of insurance.

For life insurance, what you are trying to do is to protect the coverage of the individual who may, by the time this current company goes under, be uninsurable. So that you are going to be looking to be able to pay a claim that may be many years in the future, and you will have time to make assessments that accumulate the necessary assets. You do not have to do it all in 1 year. It is not like the situation where you have hospital bills to pay or anything of that sort.

Another factor is that the liabilities held by companies tend to be fairly conservatively estimated, so that you might find a buyer for a block of business who would take something less in assets than the liabilities, and still be able to make money in the long run on the business. So that is one of the very key uncertainties that Mr. Sutton was referring to, and it is just much too early to have a good feeling about where the situation stands for Executive Life.

Senator **BRYAN**. Mr. Washburn and Mr. Borman, are you as sanguine as Mr. Sutton about the ability of the guaranty funds to absorb the kind of potential failures that Mr. Sutton hypothesizes are within the range of possibility if the economy continues to——

Mr. **WASHBURN**. When we sat down to rewrite the guaranty fund law, I think in 1986, we were looking at the possibility of two large insurance companies or one large, several medium, and a series of small ones. And again, we looked at sort of the same thing.

The payout pattern is very different, depending on the type of business that the company had, when it is going to have to pay it out. It is not like a depository institution where it has got to give the money out. You are really trying to provide benefits for people.

And the asset base is left, which is why from a regulator's standpoint you want to move in on a company as quickly as you find them hazardous. As an example, Executive Life. You, because one of the key elements is how far under is that company in terms of what is going to happen for policyholders, and how are they going to be treated by the guaranty fund.

And we have taken over a number of life insurance companies in Illinois. And often as they say you are able to sell a block of business, where someone will pick it up at a reduced amount because the business does not pay out for quite some time. So there are just a number of different methods you use to try and mitigate the problems involved with a guaranty fund.

I should say one more thing about guaranty funds. The guaranty fund has to provide to the commissioner its plan of payment for the policyholders. And if the commissioner is not satisfied with that plan of payment, he takes over the guaranty fund. So the commissioner ultimately can run the guaranty fund all by himself. I know of at least one instance in which that has happened, although fortunately there was a solution to it, and the commissioner did not have to run it. That was in Illinois.

So there is a fail-safe mechanism. If the members of the guaranty fund do not provide for the types of assistance that the commissioner deems the guaranty fund is liable for, he can actually take over the guaranty fund.

Senator **Bryan**. Mr. Borman, what is your feeling about the strength and the ability of the guaranty fund to withstand the kinds of potential losses that Mr. Sutton describes?

Mr. **Borman**. I am not as concerned about the strength of the guaranty funds. I think the, my concern is with, particularly if you look at the Baldwin-United situation as an example, the delay that has been involved in making payments in the past.

I anticipate in Minnesota that there will be litigation over issues of coverage, and that that litigation will delay payments for some period of time. In the Baldwin-United situation, it was 3 or 4 years. There will be litigation, my guess is, in California. There will be litigation perhaps in every State.

And if I could bring you back to the recommendation I was promoting earlier, we tried to adopt the NAIC model guaranty fund law, which would have clarified much of those, many of the issues that I think will be or could be litigated in the Executive Life Situation. So, I think the capacity is there; I am more concerned about the delays that will be caused by litigation.

Mr. **Minck**. Mr. Chairman, before going on, could I amplify the Baldwin-United event, because I was pretty heavily involved in it.

Senator **Bryan**. Sure.

Mr. **Minck**. Just to clarify the situation for you. The situation was one in which there were many corporations involved, some 10,000 law suits, the Internal Revenue Service and all sorts of other people involved. Victor Palmieri had the job of rehabilitating or taking care of not only the life insurance companies involved, but several hundred other corporations that were related in a very complicated fashion.

But even in those 4 years, claims continued to be paid to people who died, annuities continued to be paid. Surrenders were not permitted except in hardship cases, but at the end of the period everybody got their full amount of guaranteed benefits, and something beyond that. And interest was credited for the period of the delay. Some people had delayed access to the funds available, but it was not that there was a complete cessation of payments.

Mr. **Washburn**. There is one factor that is causing some real new concerns in liquidations and being able to pay policyholders, and that is the Federal Priorities Statute, that was passed in, I think, 1795. The Treasury Department has started to use the Federal Priorities Statute on liquidations and insolvencies, maintaining that it is not the business of insurance, and thus falls under the Federal Priorities Statute, and their usual charge, then is that anyone who makes any payments before Uncle Sam is fully paid off, whoever makes that payment is in jeopardy.

That would include the guaranty fund. They have in some cases attached commissioners' homes. The problem is that they do not feel a necessity to tell you exactly what all they are assessing under the Federal Priorities Statute; they just restrict your ability to pay. Now, there have been a number of discussions with the Treasury Department over this. We have not really proceeded—I say we, I am no longer in the business—but when I last left there was not a completion on this.

This can cause a problem in future insolvencies, I think, in terms of being able to pay, because no assets are able to be used under the Federal Priorities Statute. Any payments to policyholders may put those making payments, either the guaranty fund or the commissioner in jeopardy, and I think it is a problem that has got to be clarified.

Senator **BRYAN**. Mr. Borman, to bear out the point that you are making here, I notice from the CRS study here that we have, that from 1983 to 1987, a period of 4 years while this workout plan was being developed, that 165,000 annuitants, with a face value of $3.4 billion, were unable to withdraw their investment, and in the meantime a reduced rate of interest was being paid on that, so that certainly bears out a point.

Let me raise an argument. If one were going to play the devil's advocate role, for the moment, in terms of State regulators, and their role, generally, in Executive Life, two things caught my attention that, I must say, disturbed me, and I want to give the two of you who are former regulators to give me your own assessment. You are not on the hot seat any longer, so you can unburden yourself freely without fear of reprisal from your respective Governors. And I know how that can go, having served in that latter position, myself.

But in December 1990, the junk bond working group issued some statements confidentially to all that indicated in effect that the studies referring to the working group illustrated the companies—referring to Executive Life, now—building to meet their obligations under adverse circumstances, and that the companies are capable of meeting all current and projected obligations.

Now I have to say, this is December 1990, then New Jersey, which I think it is fair to note, parenthetically, does not have a guaranty fund, seeks to require the infusion of additional $500 million in capital, and there is an NAIC resolution that just excoriates the New Jersey commissioner for action that I do not want to say—it was characterized as reckless. But, I mean, I am sure we will have a copy of that resolution here just for a moment to read from it.

In other words, taking him to task for what, to a lot of people would say, was fairly aggressive action to protect the policyholders of New Jersey. Now this is December 1990, so we are not going back into the mid-eighties or even 1988 or 1989, or even January when you came on board, Mr. Borman, there, in Minnesota. You kind of get the impression, I must say—and this may be unfair, and I want you to really put into the record your response to it, if you disagree with it—is that kind of everybody is held in check, that we have all, as the fifty insurance commissioners, all need to be in the same harness, and if somebody gets too aggressive in regulating or enforcing, then we give him the whip hand, or her, of the NAIC by a resolution sanctioning and condemning him.

And if that is true, then that suggests that the level of enforcement is the least common denominator of action. Can you respond to that, Mr. Washburn, and you can be harsh with my observation.

Mr. **WASHBURN**. From what I know of what New Jersey did, they did not ask for new capital in the Executive Life; they asked for $500 million to be put in just New Jersey

Senator **BRYAN**. Yes, that is true.

Mr. **WASHBURN**. If you are operating with a troubled company, as an example, you start to chop up blocks of it, and you have no idea where policyholders are, or any—I mean, you have really dismantled the company that may be in fine shape prior to the dismantling.

The problem with trying to request separate deposits, especially—and I have no idea of how it affected New Jersey or how much they hit in policyholders, or something of that sort—but the thought of demanding special deposits from troubled companies is not new, but it causes a major problem for a workout condition for a company.

As an example, if California did not have that $500 million right now, if that were in New Jersey and subject to New Jersey's control, and the commissioner in California is trying to sell that company, and has got a successful buyer for that company, that is willing to infuse cash, he now not only has to deal with California, he has to deal with New Jersey. It presents a whole new obstacle to trying to work out things for a company.

Now, I say that from having no knowledge at all about what New Jersey was looking at, or what anybody else, but my understanding was they were asking just for a separate deposit, not for new money into the company.

Senator **BRYAN**. I believe that is correct, Mr. Washburn, but it does kind of raise the philosophical question as to whom the insurance commissioner is obligated. I suppose, as a former governor, my view would be, gee he or she ought to be responsible to the people in that particular State, those policyholders, and to do and take whatever actions are necessary to provide them with a maximum level of protection, as opposed to an obligation to the NAIC to do collectively what might appear to be, I mean——

Mr. **WASHBURN**. But Senator, if the obligations for New Jersey are $800 million, and his doing the $500 million causes major problems in trying to rehabilitate, he has not helped the policyholders in New Jersey.

Senator **BRYAN**. And one can make that argument.

Mr. **WASHBURN**. The problem you have got with a troubled company, and a series of independent fiefdoms, as I talked about State regulation in the end, is you have either got to try to work a problem out together, or if you collect, if you singly try to take it apart, there is no workout. You are gone.

Now I only say that, having had a large company go down and trying to work out the problems of all the States for that large company. You are aware of the different problems different States have with a company when you are trying to work it out. That is one of the things you are looking at. But I can understand why many of the other States would not want New Jersey to just take $500 million. Then they are all going to be forced to try to pick at that carcass until there is nothing left.

Senator **BRYAN**. I suspect that from the point of view of the Governor, who is ultimately accountable to the people in those States, that he or she would feel some sense of relief if the insurance commissioner in his or her State, at least in the case of Executive Life, had been early on, you know, pointing out the dangers and taking the affirmative action, because Mr. Borman laments after his arrival on the scene that, I believe the language that you use in your written testimony, Mr. Borman, is that the attitude in California was uncooperative, as you tried to get the kind of information that, as a new commissioner, you needed to evaluate just what kind of condition Executive LIfe was in.

Let me ask you to respond, perhaps, to that and the broader question about the NAIC's actions that, again, appears to be in hindsight incredibly optimistic in terms of the condition of the company's ability to meet its financial obligation, and seems to be somewhat intimidating for those commissioners who may want to step out front and say, "Look, I do not agree with this overall buyout plan. It is pie in the sky. It will never happen. We had better cut our losses now, and rein these folks in."

Mr. BORMAN. I guess maybe the best way to respond is separating the types of activities that the NAIC undertakes, and I think as a policymaking body, as a legislative body, as a standard developing body, they are outstanding. And their knowledge of the industry, and they are working with the industry to develop sensible standards and solutions to problems, is one of the best forums for developing the uniform minimum standards I am advocating, but in their executive or administrative capacity I think they are weaker, and my experience was that I was discouraged from acting independently.

I think if you look, you are a member of a collegial body, and you know how hard it is to take, to make difficult decisions when there are 50 or 100 people that you have to deal with, and I think that is the problem that you find when a First Executive situation arises. I mean, I think they should have been taken over, put under supervision, much more severe action should have been taken late in 1989 or early in 1990.

It was not, and I think that is a tendency in an organization like the NAIC to try to work together for everyone's benefit and not to make the really hard decisions sometimes you have to make as an administrator.

Senator BRYAN. Mr. Borman, is it fair to raise that question in this context, too? A number of you were making inquiry, urging California to be more aggressive. As the situation unfolded in 1989 and 1990, I guess in particular, one gets the impression, and perhaps you have already explained the reason for it, as to why more aggressive actions was not taken on the part of those individual regulators who were urging California to do certain things and, for whatever reason, the regulator there in California did not do them.

Do State commissioners generally have the authority that, even though you would be a nondomiciliary State, as it relates to Executive Life of California, can you shut down the operation and say, "Look, I do not know what is wrong out there in California; I know the NAIC would like us all to stay together, but I just am not satisfied that the buyout plan has any realistic prospect of working itself out, and every day this company continues to operate. New policyholders can be affected, and I would rather be accused of early action rather than doing too little too late." Can you respond generally to that?

Mr. **BORMAN**. As a State commissioner you have authority to do a number of things when you see a troubled company, and I went through those considerations in February and March 1990, and again revisited them in November 1990. You can take various levels of enforcement action, the most severe being preventing a company from writing any new business in your State or withdrawing their certificate, which means that they cannot do business in your State anymore.

I guess that is not what Massachusetts and New Jersey did, but they took—or did they? Did they prevent them from writing business in the States? You cannot close down the company from doing business in the other 49, but you can in Minnesota.

Senator **BRYAN**. No, I understand that.

Mr. **BORMAN**. And we could have done that.

Mr. **WASHBURN**. I have in my testimony that that is one of the abilities you have in State regulation is, you can start to shrink a company's market, and indeed not as much life insurance, to be quite frank, for property casualty. In those instances, we have often taken an action. And it is easier to take an action, as I put in there, as a nondomiciliary State.

If I am shutting down an Illinois company, I am shutting it down nationally. And that company is going to want to go to court. I am going have to have all the proof on how insolvent I think it is. I am going to have a whole series of different levels of proof I need for my action on an Illinois company than I am on a company from another State. And in that way you actually do shrink a marketplace for a troubled company. Often that happens.

Senator **BRYAN**. Mr. Sutton, let me swing the questions back to you. Then we will conclude. You have all been very patient for a long afternoon, I know. Mr. Weiss, Tuesday, offered some testimony, and you may not have had a chance to read it, and I want to give you a chance to get a copy of it, but he made a couple of suggestions. He talked about there should be a national standard imposed by Federal law. He said, "Look, there ought to be something akin to a prospectus that ought to be available at the point of sale, that is, something that indicates, you know, the quality of the company, that the prospective purchaser is getting." And he believes that there ought to be some protection, or at least some measure which would encourage the rating services to be much more forthcoming in terms of their reservations, about the financial condition of these companies. And he speculates, I suppose, for lack of a better word, that indeed these companies—A.M. Best and Moody's and Standard and Poor's—may have been reluctant to be more forthcoming, because they were fearful that they may face some legal reprisal in the form of lawsuits. What is wrong with those suggestions?

Mr. **SUTTON**. Mr. Chairman, let me give you my personal opinions and ask Dick Minck to provide some as well for the ACLI. Taking up the latter issue first, I do not really have any knowledge of the extent to which these legal threats may have been at issue in terms of S&P and Moody's. My personal opinion is that they did not play a very large part. It seems to me that those organizations have been rating other kinds of companies, noninsurance companies, in large numbers and for a long time, and if that had been a factor, it would have been addressed, initiated by them many years ago. So, I do not know that that is a problem.

Senator BRYAN. But they did miss by a country mile.

Mr. SUTTON. Absolutely, and you talked about credibility earlier, of those who had made representations about solidity and strength of the industry. That is a major problem for all of the rest of us, the deterioration of the credibility of S&P. So I agree with you in that sense. I think I would like them to respond on their own behalf.

Senator BRYAN. I understand.

Mr. SUTTON. On the topic of disclosure, generally speaking I am an advocate of openness, but on the other hand you have to ask what you are being open about, because if you delivered a prospectus for a life insurance policy, you could essentially hide all kinds of things simply by very complete disclosure. Discussions of pricing elements and investment strategies would be so complex and so involved that it is inconceivable to me that any buyer would actually read the prospectus and understand what it was saying. So, I do not have a lot of confidence in the practical impact of having a detailed technical prospectus. What I would rather have is credible rating services, who are able to take into account all of the appropriate factors, to be able to have an insight into the company operations in terms of the quality of their management, the quality of their assets, and other relevant items, and to be able to give great credibility, if not absolute reliance, to those rating services.

Senator BRYAN. Is the concept of a disclosure offensive to you, assuming that you could get a disclosure that is not so highly technical as to be actually meaningless? But I mean, is the concept of full disclosure at the point of sale, assuming that you could get something that is more understandable than the complexities might permit it to be? You can be so complex that nobody is going to read it, and those that do——

Mr. SUTTON. My personal opinion is that I would not have any problem with a kind of disclosure that could be communicated simply, but was based on extensive analysis by someone capable of making the appropriate analysis.

I would not like a simplistic disclosure that could cause great dislocation because it did not recognize all of the factors in what is, in fact, a very complicated business.

Senator BRYAN. How about the national standard? Mr. Borman seems to have some appetite for that recommendation. Let us assume for the sake of argument that the NAIC standard is an objective. It is one we can all agree on. Any problem with that being made a mandatory standard by Federal law?

Mr. SUTTON. As a company doing business in most States we would be very much in favor of uniformity. It is very difficult, an administrative burden, to vary State by State in terms of the things that you have to do. So, uniformity I would fully support.

The issue of how that uniformity should be achieved, I think is open to question at this point. My first preference would be that the uniformity could be achieved by the rational actions of the NAIC as they flow through the States, and that Federal intervention would not be specifically necessary.

As I mentioned in my testimony, if that does not occur, I think that myself, as well as many others, would rethink that position.

Senator BRYAN. But you yourself, Mr. Sutton, recounted for us during your testimony your experience in Sacramento.

Mr. SUTTON. Absolutely. I am saying right now, if I may add, I think John Garamendi, because of the situation in California and the fact that he is an elected commissioner, will certainly make a specific difference in that State.

But I think that further, the financial euphoria of the 1980's that I mentioned, that really put blinders on a lot of people, is past, and that right now, because of the attention focused on this issue, is an ideal time to pass legislation through the States without any significant opposition, so I am fairly optimistic about the effect of State regulation at this point.

Senator BRYAN. Mr. Sutton, I am going to give you an opportunity to respond to a question in writing. Mr. Borman outlined some very thoughtful recommendations. You probably have not had a chance to study them, and I am not going to ask you to respond spontaneously to them, but we would like to leave the record open on that.

One of you commented that—and I guess it was you, probably, Mr. Sutton—that you were trying to get some statutory standard in Sacramento as to the amount of junk bonds in a portfolio. Did I understand your testimony correctly?

Mr. SUTTON. Yes, that is correct.

Senator BRYAN. The premise of that seems to be that only by that statute could the Commissioner take the appropriate action.

Now, we are told—and we have certainly seen an extraordinary ingenuity in terms of new financial instruments. Part of the debate in the Congress between who ought to have the regulatory authority—the Commodity Futures Trading Commission or the Securities Exchange Commission—on these so-called hybrids, these instruments that are being developed by people that are extraordinarily creative, is are they fish or fowl, are they commodities or are they securities, and one can just get kind of a glimmer that, indeed, it is pretty hard sometimes to characterize those.

One ought not to assume, even though the euphoria of the 1980's is past, that there are not going to be some very creative people out there creating these kinds of instruments. If our response is going to be, "Well, gee, as each one of these new instruments comes out we are going to have to go to Sacramento or various State capitols to make sure that we do not get a portfolio overloaded with them, we are always going to be behind the power curve."

How do you respond to that?

Mr. SUTTON. Well, I would agree with you in the sense that a focus on junk bonds, per se, with whatever definition you may give them, does not go far enough, that there needs to be an appropriate set of investment regulations under which insurance companies operate, perhaps more a la New York's.

The NAIC does have a model that encompasses a number of items other than junk bonds, or in addition to junk bonds, as well as concentration of risk in a particular issuer. I think that a set of appropriate investment guidelines is appropriate and should be enacted.

Senator **BRYAN**. Well, gentlemen, I thank you very much. Let me just give you the opportunity—if any of you has a need to add a point to what you may not have been able to make, Mr. Borman, let me give you the opportunity, if there is something in addition that you would like to add?

Mr. **BORMAN**. No, thank you very much. I do not have anything else.

Senator **BRYAN**. Well, we appreciate your testimony. It was particularly helpful. Mr. Washburn, anything else that you would care to add?

Mr. **WASHBURN**. Well, I think the standards issue is an important issue. I think that, to be quite frank, when we started looking at standards for the NAIC for all States, I think that there was a thought process at that time that in some form or fashion they were going to be mandated.

Senator **BRYAN**. Your testimony was also much appreciated.

We appreciated Mr. Sutton. If there is anything you would care to comment on, we appreciated your testimony. You were most helpful to the committee.

This subcommittee hearing will stand in recess.

[Whereupon, at 4:55 p.m., the subcommittee adjourned.]

TAKEOVER OF FIRST CAPITAL LIFE INSURANCE CO.

THURSDAY, MAY 23, 1991

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
Washington, DC.

The committee met, pursuant to notice, at 3:05 p.m., in room SR-253, Russell Senate Office Building, Hon. Richard H. Bryan, presiding.

Staff members assigned to this hearing: Moses Boyd and Linda Lance, professional staff members; and Alan Maness and Sherman Joyce, minority professional staff members.

OPENING STATEMENT BY SENATOR BRYAN

Senator BRYAN. Let me take this opportunity to welcome our distinguished panel and everyone to the hearing today.

This marks the fourth in a series of hearings that this committee has held on the problem of insolvency in the insurance industry.

Let me preface by remarks by extending my apologies to the members of the panel for the delay. As I am sure you have been informed, we had a series of back-to-back votes that were scheduled to commence at about the same time that our hearing was scheduled to begin. I thought it best that we try to provide as much uninterrupted testimony as possible.

On February 27, this committee held its first hearing to ask the threshold question, and that is, how serious are problems of insolvency in the insurance industry, especially the life insurance industry. At that time, the National Association of Insurance Commissioners responded by telling us that the system has well served insurance consumers for more-than a century and is functioning well and getting better.

The U.S. Department of Commerce also responded to the call of the committee and told us that overall, life insurers were financially sound and healthy in 1990, solvency of a few smaller companies, however, is threatened by excess investment and questionable real estate and junk bonds.

The A.M. Best Co., a leading insurance rating firm which provided ratings for Executive Life and First Capital, testified our findings and expectations do not support the belief that the insurance industry is on the verge of a collapse similar to that of the savings and loan industry.

Less than 2 months after that hearing, the largest insurance company failure in American history occurred, affecting every State in America and placing at risk the life insurance policies and pension plans of more than 400,000 people.

On April 11, the State of California seized control of Executive Life Insurance Co. of California and some 5 days later, on April 16, the State of New York seized control of Executive Life of New York. Together, the two companies held $50 billion in business and more than 400,000 policies with policyholders in every State.

In hearings on May 9 and 16 of this year, the committee looked into and examined the Executive Life failure. Then just a few days after the Executive Life hearing, the next largest insurance industry failure in American history took place. On May 13, the State of Virginia seized control of Fidelity Bankers Life Insurance Co. The next day, on May 14, California again found itself in the life insurance business with the seizure of First Capital.

Both companies are subsidiaries of the same holding company, First Capital Holding Co. of California. Together, these two companies have close to $35 billion in business and more than 500,000 policies outstanding. Policyholders reside in some 49 States.

Since we heard the testimony on February 27, telling us not to worry, that the problems might be with a few small companies, more than 1 million policyholders have their life investments at risk. Life insurance and annuity policyholders around the country are asking themselves, Is my policy safe? Who is next? How secure it my own pension?

There are some common denominators. The Executive Life insurance companies had almost 70 percent of their assets in junk bonds. Fidelity Bankers and First Capital had around 40 percent of their assets in junk bonds, a prime example of the legacy of loose regulation, greed, and risky investments that characterized much of the 1980's.

All of these companies were suffering major offering losses, some amounting to millions of dollars. But despite the losses, despite the unsound junk bond investments, all of these companies were given top ratings with the major rating firms, A.M. Best and Standard & Poors, up until just a few months before their seizures. And State regulations failed to prevent the downfall or to alert customers.

Senator Hollings, Senator Gorton, and I have written the Justice Department following the hearings on Executive Life, asking for a thorough investigation into possible fraud and other criminal activity. It is absolutely essential that as the problem develops, that Justice Department step in to ensure, if there is any criminal wrongdoing, that those responsible must be punished.

Since our letter, I have talked with Attorney General Thornburgh personally and met with members of his staff. It is my belief that a Department of Justice investigation will be undertaken shortly and that it will be handled at the top level of the U.S. Attorney's Office in Los Angeles.

We face the unhappy prospect, the taxpayers throughout the country will be drawn into the Executive Life failure. Yesterday, California insurance commissioner, John Garamendi, raised the issue of a deferral of the enormous claim of some $643 million by the Internal Revenue Service until policyholders are first paid. Mr. Garamendi also said he believed the uninsured annuities of Executive Life policyholders should be covered through the Federal Pension Benefit Guaranty Corporation.

If the taxpayer is to bear the burden of these life insurance failures, then the Congress has no choice but to take steps to ensure that the regulatory policies and structure of the life insurance industry is fully capable of insuring the financial soundness of that industry.

I am delighted, this afternoon, to welcome three distinguished panelists. Mr. Steven Foster, State Commissioner for the Virginia Bureau of Insurance, Mr. Richard Baum, the Chief Deputy Insurance Commissioner for the State of California, who also has served as the conservator running Executive Life of California. And we will also hear from Mr. Benjamin Stein, an economist from California who will discuss the dangers involving junk bond investments by life insurance companies.

Unfortunately, today we will not hear from representatives of the following companies, which again, have declined to testify; First Capital Holding Co., A.M. Best, and Standard & Poors Rating Services.

Gentlemen, let me welcome you to the committee hearing and again, offer my apology for the delay in the commencement of this hearing. Let us begin, if we may, this morning, by hearing, Mr. Foster, from you first.

OPENING STATEMENT BY SENATOR ROBB

Senator ROBB. Mr. Chairman, I am pleased that the committee is continuing its hearings on the issue of insurance insolvency. This is a real concern, in light of the collapse of units of First Executive Corp., First Capital Holdings Corp., and Fidelity Bankers Life Insurance Co.

Mr. Chairman, I would also like to note the presence of Mr. Steven Foster, Commissioner of Insurance, State Corporation Commission, of the Commonwealth of Virginia. Fidelity was placed in receivership by the Commonwealth on May 13. Fidelity Bankers has 213,000 life insurance customers and 97,000 annuity holders in 49 States. The company has $4.1 billion in assets, slightly smaller than First Capital Life.

On May 13, the Circuit Court of Richmond appointed the State Corporation Commission Receiver for Conservation and Rehabilitation of Fidelity. In a separate order, the State corporation commission appointed Mr. Foster as deputy receiver. The State is now in control and is supervising the daily operations of the insurer. I understand that as of March 31, the company reported a surplus to its policyholders in an amount exceeding $114 million. However, some 37 percent of Fidelity's investments is in high-yield junk bonds, some of which have defaulted in recent months.

The issue of insurance company insolvency has been often compared to the problem of savings and loan institutions and banks. Federal regulators and the Congress have been criticized for their failure to act when financial institutions ceased to be profitable. The Commonwealth of Virginia has once again illustrated that the States can act in a timely manner. Mr. Foster is to be commended for moving with dispatch in taking over Fidelity.

Senator BRYAN. We will not hear from Mr. Foster.

STATEMENT OF STEVEN T. FOSTER, COMMISSIONER OF INSURANCE, STATE CORPORATION COMMISSION, COMMONWEALTH OF VIRGINIA

Mr. FOSTER. Thank you. My name is Steven T. Foster and I am Commissioner of Insurance at the State Corporation Commission of the Commonwealth of Virginia. It is a pleasure to appear before you.

My testimony will deal with actions taken in Virginia relative to Fidelity Bankers Life Insurance Co. headquartered in Richmond. Virginia's insurance regulatory scheme differs in some respect from those in other States. I am appointed by the three-member State corporation commission and serve at their pleasure. As commissioner of insurance, I am responsible for the oversight and supervision of the activities of the bureau of insurance, which is the commission's largest division.

On Monday, May 13, 1991, upon application of the State corporation commission, the Circuit Court of the City of Richmond appointed the commission receiver for the conservation and rehabilitation of Fidelity Bankers Life Insurance Co., which is, of course, a Virginia domestic insurer. By separate order, the commission appointed me as deputy receiver.

The appointment of receiver culminated a year of close scrutiny of the operations of this insurer by the bureau. The commission asked the court to appoint the commissioner receiver in order to prevent, and I want to underscore that, to prevent the company from reaching a financial condition which would be hazardous to the policyholders and creditors of the company.

I am pleased to report, Mr. Chairman, the company has been under the control and direction of the commission and my office since that day, Monday, May 13. It is important to emphasize, at this time, that there is no finding of insolvency. In fact, as of March 31, 1991, the company has reported surplus to policyholders in an amount exceeding $114 million.

I would like to, at this time, provide some background of the events that led up to the appointment of the commission as receiver. Subsequent to the filing of the company's 1989 annual statement, which we received in March 1990, we began an in-depth review and analysis of the financial condition of the company. Specifically, the bureau had concerns at that time, as to the company's level of capitalization, its holdings in noninvestment grade bonds, and the nature of certain annuity products.

Following this initial review, the bureau directed Fidelity Bankers to engage the actuarial firm of Milliman and Robertson to conduct a valuation actuarial analysis. At the same time, we retained our consulting firm of Mercer, Inc., to address the company's exposure to interest rate fluctuations, bond defaults, and the company's potential inability to deal with cash surrenders and policy lapses. Although the company was in no immediate danger, the bureau had concerns that the company needed to take measures to protect itself from these exposures.

The retention of these firms marked the beginning of and the acceleration of the preparation for the regular triennial examination of this company, which otherwise, would have commenced in 1992. Instead, it began in these months of 1990.

Discussions were held between the staff of the bureau and these consulting actuarial firms. The reports were received by these firms in October and November 1990, respectively. Following the receipt of these reports, the bureau required Fidelity Bankers to begin the reporting of financial data to the bureau on a monthly basis.

In addition, close scrutiny was given to the 1990 annual statement which came in during the early part of this year. At this same time, the decision was made to commence the preliminary onsite work necessary to launch the full examination of the insurer. Our examiners have been onsite since the first week of March, working closely with company personnel to monitor, particularly, the amount of annuity surrenders being requested. During the first 3 months of 1991, request for surrenders averaged approximately $1.9 million per day.

Publicity surrounding action taken by both California and New York regulators, with regards to Executive Life Insurance Co. and Executive Life of New York, served to increase the level of surrenders requested of our domestic, Fidelity Bankers. This was further compounded less than a month ago when publicity was given to negotiations between California regulators and First Capital Life Insurance Co., its ultimate parent, First Capital Holdings Corp., and in turn, Shearson Lehman Brothers and American Express, who own a controlling interest in the holding company.

Surrender requests, by this time, had climbed to over $23 million, and on May 10, the last business day before the commission was appointed receiver, it had reached almost $25 million.

Although there was and is no indication of insolvency, the State corporation commission and I wanted to act expeditiously to stem the flow of cash and protect the liquidity of the company. The tenfold increase in surrenders, combined with concerns with the company's holdings in noninvestment grade bonds, and the potential for upstreaming of money to the parent holding company, provided sufficient impetus for swift regulatory action.

We are optimistic, Mr. Chairman, about the future of Fidelity Bankers Life Insurance Co. There is no indication of insolvency and, at this time, there is no expectation of any guaranty fund assessment being necessary. A review of the company's investment portfolio and liabilities began in earnest upon our appointment as receiver. Once we have finished this review, we will analyze and where appropriate, pursue a variety of strategic financial alternatives to restore and stabilize the company's capital base.

We are optimistic at this time that our regulatory action with regard to this company will provide the needed protection to policyholders throughout this country.

Thank you for this opportunity to testify, Mr. Chairman. I will be happy to answer any questions you may have.

[The prepared statement of Mr. Foster follows:]

PREPARED STATEMENT OF STEVEN T. FOSTER

My name is Steven T. Foster and I am commissioner of Insurance of the State corporation Commission of the commonwealth of Virginia. It is a pleasure to appear before you today to testify at this committee hearing.

I have been informed that the purpose of today's hearing is to examine the recent action taken by regulators in Virginia and California relative to Fidelity Bankers Life Insurance company and First Capital Life Insurance company, respectively. My testimony will deal exclusively with actions taken in Virginia relative to Fidelity Bankers Life Insurance Company headquartered in Richmond. I am not prepared, nor would it be appropriate for me to comment on actions taken by the Insurance commissioner of California relative to Fidelity Bankers affiliate company First Capital Life Insurance Company of California.

Virginia's insurance regulatory scheme differs in some respects from those in other states. I am appointed by the three members of the State corporation commission and serve at their pleasure. As commissioner of Insurance, I am responsible for managing and supervising the activities of the Bureau of Insurance, which is the largest division of the State Corporation Commission. In addition to insurance, the State Corporation Commission regulates financial institutions, securities, motor carriers, railroads, and public utilities including gas, electric and telephones.

On Monday, May 13, 1991, upon application of the State Corporation Commission, the circuit court of the City of Richmond appointed the State Corporation Commission Receiver for Conservation and Rehabilitation of Fidelity Bankers Life Insurance Company, a Virginia domestic insurer. By separate order, the State corporation commission appointed me Deputy Receiver. The appointment of a Receiver for Fidelity Bankers Life Insurance Company less than two weeks ago culminated a year of close scrutiny of the operations of this insurer by the Bureau of Insurance. The State Corporation Commission asked the circuit court of the city of Richmond to appoint the commission Receiver in order to prevent the company from reaching a financial condition which would be hazardous to policyholders and creditors. I am pleased to report that the company has been under the control and direction of the State Corporation Commission since Monday, May 13, 1991. Although we have retained senior management of Fidelity Bankers, as well as all other employees, the Receiver has been in control and is supervising the daily operations of the insurer. It is important to emphasize at this time that there is no finding of insolvency; in fact, as of March 31, 1991, the company has a reported surplus to policyholders in an amount exceeding $114 million.

I would now like to provide some background as to the events that led up to the appointment of the State Corporation Commission as Receiver for Fidelity Bankers Life Insurance Company. Subsequent to the filing of the company's 1989 Annual Statement in March of 1990, the Bureau began an in-depth review and analysis of the financial condition of the company. In Virginia, on-site examinations of our domestic insurers are conducted every three years generally. The last on-site examination of this insurer was performed in 1989 for the period ending December 31, 1988. The 1989 Annual Statement filed in March of 1990 brought to light several areas of concern to the Bureau. Specifically, the Bureau had concerns as to the company's level of capitalization, its holdings in non-investment grade bonds ("junk bonds"), and the nature of certain annuity products which might lead to a run on the insurer, i.e., the lack of surrender charges.

Following this initial review, the Bureau of Insurance directed Fidelity Bankers Life Insurance company to engage the actuarial firm of Milliman and Robertson, Incorporated to conduct a "valuation actuarial analysis" which was to address the company's exposure to interest rate fluctuations, bond defaults, and the company's potential inability to deal with cash surrenders and policy lapses. The actuarial firm of Milliman and Robertson, Incorporated has had considerable experience in this type of analysis.

Although the company was not in immediate danger, the Bureau had concerns that the company needed to take measures to protect itself from the above-referenced exposures. The engagement of Milliman and Robertson, Incorporated by Fidelity Bankers at the direction of the Bureau of Insurance thus marked the beginning of, and accelerated, the preparation for the regular triennial examination of the financial condition of the company, which would otherwise have commenced in 1992. The Bureau of Insurance, in turn, involved the services of William M. Mercer, Incorporated, consulting actuaries. The role of this firm was to assist in defining the specifications for the valuation actuarial analysis, to review the assumptions and conclusions of the Milliman and Robertson, Incorporated analysis, and to assist the Bureau generally in the review of the Milliman and Robertson, Incorporated report. William M. Mercer, Incorporated is one of the Bureau's consulting actuarial firms used on an on-going basis.

Discussions were held by and between staff of the Bureau of Insurance, Fidelity Bankers Life Insurance company and the actuarial consultants during the latter part of 1990. The analysis performed by Milliman and Robertson, Incorporated and the corresponding review given by William M. Mercer, Incorporated were delivered to the Bureau in October and November, 1990, respectively. Following the receipt of these actuarial reports, Bureau staff requested additional work using revised and up-dated assumptions. Furthermore, the Bureau required Fidelity Bankers Life Insurance Company to begin the reporting of financial data to the Bureau on a monthly basis. Prior to this monthly reporting requirement; Fidelity Bankers had been required to report to the Bureau on a quarterly basis.

The Bureau of Insurance monitored the monthly reports as submitted by the company during the early part of 1991. In addition, close scrutiny was given to the 1990 Annual Statement which was filed as required by Virginia law in the first quarter of 1991. At the same time, the decision was made to commence the preliminary onsite work necessary to launch an early full examination of the insurer. Bureau examiners were sent to the company offices in Richmond during the first week of March. These examiners worked closely with company personnel and, in particular, monitored the amount of annuity surrenders being requested. During the first three months of 1991, requests for surrenders averaged approximately $1.9 million per day.

It appears that publicity surrounding action taken by California and New York regulators with regards to Executive Life Insurance company and Executive Life Insurance Company of New York, respectively, served to increase the level of surrenders requested of Fidelity Bankers Life Insurance Company. This situation was compounded less than a month ago when publicity was given to negotiations between California regulators and First capital Life Insurance company and its ultimate parent, First capital Holdings corporation and Shearson Lehman Brothers Holdings corporation and American Express Company. Shearson Lehman holds a controlling interest in First Capital Holdings Corporation, which is also Fidelity Bankers' ultimate parent. Surrender requests of Fidelity Bankers had climbed to over $23 million on May 10, the last business day before the State corporation commission was appointed Receiver for Fidelity Bankers.

Although there was, and is, no indication of insolvency, the State Corporation Commission and I wanted to act expeditiously to stem the flow of cash and protect the liquidity of the company. The tenfold increase in annuity surrender requests combined with concerns about the company's holdings in non-investment grade bonds, the potential for upstreaming of money to the parent holding company, and the nature of some of the annuity products provided sufficient impetus for swift regulatory action. Although our action was separate from that taken by California regulators, our two offices had been working closely and cooperating to the fullest extent possible in the days leading up to the receivership. We look forward to working with California regulators, the NAIC and the other states in the successful conservation and rehabilitation of our domestic insurer.

We are optimistic about the future of Fidelity Bankers Life Insurance company. As I mentioned earlier, there is no indication of insolvency; and, at this time, there is no expectation of any guaranty fund assessment being necessary. We have assembled a team of nationally-recognized experts including financial and legal advisors and actuaries to determine the company's current financial condition and to determine the best course of action to protect the company's policyholders.

A review of the company's investment portfolio and liabilities began in earnest upon appointment of the Receiver. Once this review is completed, we will analyze and, where appropriate, pursue a variety of strategic financial alternatives to restore and stabilize the company's capital base. There are a number of options which are being considered at this time. One would involve a direct equity infusion into the company. Another alternative would involve the sale of the entire company or, in lieu of such a sale, the sale of blocks of annuities and whole life policies to third parties. In addition, we will also consider our options with respect to selected dispositions of the company's high yield non-investment grade portfolio.

We have retained First Boston Corporation to assist in asset management and investment banking. It is in the best interest of all parties concerned, primarily policyholders, that we move as quickly as possible to preserve the company's value as a going concern and to stabilize the relationship between the company and its policyholders, general agents and broker-dealer distributors. Our first and foremost interest is to protect the investments of policyholders of Fidelity Bankers Life Insurance company. We are optimistic that Virginia's timely regulatory action with regard to this company will provide the needed protection to policyholders throughout this country.

Thank you for the opportunity to testify before this Committee on Virginia's recent action involving Fidelity Bankers Life Insurance Company.

Senator BRYAN. Thank you very much.

Mr. Stein, we may have to run over for another vote, and we would want to have the full benefit of your testimony, so let me ask you to testify next.

STATEMENT OF BENJAMIN J. STEIN, ECONOMIST, MALIBU, CA

Mr. STEIN. Thank you for calling me. I was called while I was on the road and so I do not have written testimony. I would like to respectfully ask if I might send you some when I get back to Los Angeles.

Senator BRYAN. That would be appropriate.

Mr. STEIN. I would like to say that what happened with First Executive and to some extent First Capital—and I respectfully tell my neighbor here to my left that I do not think the saga of his domestic insurance company is anywhere near at an end—is not an accident. It was not the result of market fluctuations. It was not the result of interest rate changes. It was not the result of unlucky investments.

It was the inevitable result of the Drexel fraud. It was the inevitable result of the creation by Drexel of captive blood bank, life insurance, and other insurance companies to buy its largely worthless junk bonds. That is, I believe there is not a precedent for this in annals of large insurance company failures. This was a purposeful looting of the policyholders by the people who ran these institutions as far as I have been able to tell.

It was orchestrated very clearly, and this has been written about in great detail by Drexel—by Drexel's many, many helpers, including a number of academics and Government officials in various parts of the country. The work and help of the NAIC was indispensable for the operation of the plan, and I think it is worth some investigation, sir, at some point, of the extent to which Drexel was bestowing favors and gifts upon so-called investigators and analysts of the NAIC.

It is, in my opinion, a national scandal that the same people who were rating the Drexel's bonds all through the 1980's were being flown first class to France and to London and to Hawaii to attend conferences to supposedly rate these bonds. It has always been a kind of interest to me why these people needed to be flown to Hawaii and to Paris to have meetings to rate bonds at the expense of the issuer. It seems to me the conflict of interest is overwhelming, and I think it would be worthwhile to investigate where a number of these analysts found employment after they left the employ of the NAIC.

It is also worth noting, by the way, that NAIC ratings of junk bonds are very different from Standard & Poors or Moody's ratings and that you can get a bond which is rated investment grade by NAIC, which is considered complete noninvestment junk by Standard & Poors and Moody's. And in fact, this was played upon very, very heavily by both First Executive and First Capital to claim they had much less junk than they did.

To examine what is actually in the coffers of these companies, as I have done in great detail with First Executive, is pretty scary. And it is pretty scary to see what they considered investment grade. Now, the end product of what happened with the Drexel insurers is going to be very similar to what happened with the Drexel captive S&L's such as Columbia and Centrust and San Jacinto and many others, which is that Drexel will have managed to compulsorily sell its junk to the taxpayers. It may be that they will be State taxpayers in this case, or it may be State taxpayers through other insurance companies. But without any wish on the part of ordinary citizens to buy Drexel junk, they are being sold, in one case through the Federal Deposit Insurance System, in the other case through various pension and insurance guarantee schemes.

This a national problem and it requires, it seems to me, a national response. Insurance, at this point, is very much of a national product. You need only turn on any national sports event to see enormous ads by national insurers. It seems to me the time has passed when it could be regulated in this crazy-quilt fashion State by State. I mean, clearly there has been a problem in doing this.

It seems to me there are a number of steps that should be taken immediately. One is the aggressive prosecution of the people who perpetrated this fraud. The idea that a fraud involving billions of dollars of totally innocent people's money should have taken place and that people who worked their whole lives will not get their annuities while the people who perpetrated this are living in enormous houses all throughout southern California and playing polo all day—and I would like to tell you I have seen them do it—is just nauseating. It is incredible to me that hardworking Americans who were openly stolen from by these insurance companies will face the spectacle of having to work late into their elderly years while the people who took from them are living the lives of kings. That is one thing.

The second thing is—and it seems to me that the fraud in the case of valuation of the bonds was absolutely clear cut. The insurance products were being sold, as you know, through brokerages, in many cases through the captive brokerages of American Express and Shearson. They were sold as brokerage products, sold as investments. They really are the same as a package of stocks and bonds with an intermediary managing them. It seems to me the same remedies for lack of full disclosure and fraud should be available to policyholders as are available to stockholders and bondholders.

And it seems to me also that the PBGC should be being a little more forthright about this than they are. They have, as you know, written an opinion that they do not think they are on the hook for these pension plans which were supposedly backed by GIC's, which were the result of terminated other kinds of pension plans. That to me is very questionable. It is questionable that an insured worker should be able to be deprived of his retirement insurance by a third person without his consent; that is, that a man who relies upon a Federal act for pension guarantee should be able to be deprived of that by something he did not himself do. Certainly, people relied on it. And where that reliance is and where it is breached, there is a gigantic problem.

There has overall, sir, been an enormous amount of fiduciary breach in this situation by academics coopted by Drexel to issue false and fraudulent reports about the default rate of junk bonds by people at investment banks throughout this country, by the lawyers and accounts who papered the deals. There are deep pockets. There is a lot of money there to be recovered, sir, by the State and Federal institutions involved from the people who made this fraud possible, and I hope you will begin to do it.

Thank you very much for letting me speak.

[The prepared statement of Mr. Stein follows:]

PREPARED STATEMENT OF BENJAMIN J. STEIN

My name is Benjamin J. Stein. I reside at 4539 Via Vienta, Malibu, CA 90265.

My educational and professional background as it bears upon this case is as follows:

I studied economics at Columbia College in New York City. I graduated with a B.A. in economics, with honors, in 1966. While at Columbia I studied in particular market functioning in free and also in not-free markets.

I worked as an economist for the U.S. Department of Commerce in Washington, DC in 1966–67, working primarily on trade in North America, and on the effects of impediments to trade in the form of tariffs and charges of other kinds.

I studied law at Yale Law School from 1967 to 1970. I graduated from Yale Law School in June of 1970. By the election of my classmates, I was chosen to be valedictorian of the class of 1970.

While at Yale Law School, I was privileged to be allowed to take courses in the Yale Graduate School of Economics. I took a course from the Nobelist in Market Theory, James Tobin, and one in corporate finance from the late Henry Wallich, for many years a governor of the Federal Reserve Board.

After graduation from Yale Law School, I served as an assistant to Robert Brown, special assistant to President Nixon for Minority Affairs, as a trial lawyer at the Federal Trade Commission, a speechwriter for presidents Nixon and Ford, a columnist and editorial writer for The Wall Street Journal, and in other capacities.

For the past seven years, more or less, my work has been focussed upon the study of fiduciary duty by officers and directors of public corporations, their accountants, law firms, and investment banks. In particular, my work has been to attempt to delineate those duties and relate them to the lawful and orderly functioning of the free market system which the laws are supposed to uphold.

For those same seven years, this work has led me to become a frequent commentator on the themes of fiduciary duty in public corporations and breaches of that duty for primarily Barron's, but also for Fortune, The New York Times, The Los Angeles Times, Investment Vision, Business Month, and many other publications.

I have served as a lecturer at the Anderson Graduate School of Management at UCLA, at the Amos Tuck School of Business Administration at Dartmouth, and at Pepperdine in Malibu. In all of these duties, my emphasis has been upon ethical duties and breaches thereof by managers of public companies.

In the same academic vein, I have served as a consultant to the U.S. House of Representatives Committee on Energy and Oversight, been a witness repeatedly before the same committee's subcommittee on Telecommunications and Finance, and been a witness before the U.S. Senate Banking Committee. I have also been a witness on numerous occasions before California State Legislative Committees (including testimony about eighteen months ago regarding First Executive in which I said that even then, by any standard of reality, First Executive was insolvent; to the contrary was then Insurance Commissioner Roxani Gillespie, who assured the committee that everything at First Executive was fine).

I have also served as a consultant and lecturer for the North American Securities Administrators' Association also on the subject of fiduciary duty, ethical breaches, fraud, and its effect upon individuals and upon the society at large.

I am the author of a portion of a leading standard text on investment banking "Investment Banking," published by Dow-Jones/Irwin). My portion is about the fiduciary duties of investment bankers.

I am also the recipient of a grant from The Twentieth Century Fund to write a book about ethical duties of managers in situations of potential self-dealing.

It has been my melancholy duty for the past several years to follow closely the misconduct of the major bad actors within the notorious Drexel Burnham Lambert scheme led by the Milken Brothers, Michael and Lowell. In that capacity, I have been following the doings and questionable acts of Fred Carr and the management of First Executive, inasmuch as Mr. Carr and his company were indispensable aiders and abettors of the Drexel fraud.

For most of that time, and especially in the more recent past, I have been appalled by the purposeful misconduct of the management of First Executive, especially in terms of the systematic jeopardizing of the savings and retirement and survivors' security of innocent Americans so as to enrich the management of First Executive, and especially the friends and colleagues of Carr at Drexel. In my opinion, First Executive management has been at the heart of the most devastating and cruel financial fraud of all time and was indispensable in making that fraud happen.

The misconduct, brazen flouting of the most basic principles of fiduciary duty, and betrayal of trust displayed by Fred Carr and his colleagues at First Executive has been so persistent, egregious, and unrepentant that it makes clear to me that further trust of these personages to manage the affairs of the bankrupt estate of First Executive would constitute an imminent and unnecessary danger to the stockholders and especially to the policyholders of First Executive and its subsidiaries.

It is important to note that the collapse of First Executive, its seizure by state regulators, and the reduction in payments to policyholders which have occurred recently are not the results of some kind of chance event. Nor are they the result of the business cycle, of new financial developments such as changes in interest rates, nor of new state or federal regulation.

The collapse of First Executive, and the losses to its stockholders, lenders, and policyholders are the necessary, inevitable result of the purposeful scheme of breaches of fiduciary duty and outright fraud of the top management of First Executive, and indeed the entire operation could not have turned out any other way than in loss to the people who trusted top management at First Executive with their money.

That is, the manner in which First Executive was run approximated a Ponzi scheme or a pyramid or a chain letter, but with many refinements, and such schemes always fall, leaving trustors with losses.

The heart of the First Executive scheme was to promise policyholders a uniquely valuable and low-priced investment, to use the proceeds of the policyholders premiums to enrich top First Executive management and their close colleagues at Drexel Burnham Lambert, especially the Milken Brothers, and in fact deliver to policyholders a drastically compromised and inferior insurance protection, which had been weakened by the siphoning off of policyholders' funds to enrich top management and the major controllers of Drexel Burnham Lambert, their accountants, lawyers, and publicists.

The siphoning off took the form of using the premiums of policyholders to buy the "junk bonds" of Drexel Burnham Lambert, which were, in fact, an investment which was drastically unsuitable for an insurance company because of its high rate of default—and which created value mainly for the insiders at Drexel Burnham Lambert who collected enormous fees upon their issuance while the buyers suffered from the defaults. The Drexel Burnham insiders, in turn, held controlling stock interests in various classes of First Executive stock and helped thereby to maintain the management positions of Carr and others at First Executive.

This is far more basic than fun and games with advanced accounting.

An insurance company works by taking in premiums from policyholders and investing them. The investments must yield, over a very long period of time, sufficient income from interest, capital gains, and redemptions to meet the promised obligations to policyholders.

If the investments chosen by the management of the insurance company predictably and consistently do not return sufficient income to meet obligations to policyholders, the policyholders will not get their stated benefits. If the investment failures are concealed from current and prospective policyholders, those policyholders will be defrauded into thinking that their insurance investments are secure when in fact they are not.

The selection of investments which would benefit Fred Carr and his management, the principals of Drexel Burnham Lambert but would hurt the policyholders of First Executive, and the concealment of the failure of the investments over many years, with the help of Carr's accountants and lawyers, is at the heart of the fraud and deceit practiced by top First Executive management. This fraud and deceit, again, was so pervasive and so conscious that it renders retention of Carr and/or his colleagues in high management control of First Executive extremely dangerous.

Some, but by no means all of the unethical and fraudulent conduct by top management of First Executive, aided and abetted by their lawyers and accountants, included:

- Over many years refusing to take adequate reserves for losses upon default of Drexel junk bond issues. It was known to the high officials of First Executive, or should have been known to them upon fairly cursory investigation, that the true rate of default of the Drexel junk bonds in its portfolio would have approximated at least three per cent per year and by some measurements would have been more like five per cent a year, well before the utter collapse of most parts of the junk bond market in the past eighteen months. This was proved thoroughly by a paper written by a well-known analyst in corporate finance, Paul Asquith.

By every known accounting principle for a fiduciary institution, sole provision for that rate of default should have been taken by First Executive and its subsidiaries. Usually a reserve for losses likely to be incurred would be taken to satisfy the need for financial statements to be economically meaningful and to reveal the substance of an insurer's condition.

Considering that the standard Drexel issue was for ten years, more or less, and that defaults were running at about three to five per cent per year, a reserve provision of about twenty five per cent of junk assets would have given investors and policyholders some idea of how adversely impacted the asset portfolio was by defaults, and how precarious First Executive's position was. Even if one assumed some residual value in the defaulted bonds, even taking the most optimistic value that has historically been associated with defaulted bonds,that they are worth about forty cents on the dollar on default, a reserve of at least fifteen per cent of the portfolio would have been absolutely minimal. In fact, Drexel defaults tend to be worth far less than forty in my experience.)

Yet First Executive at no time took a reserve of anywhere near fifteen per cent, and for most of its life, took negligible reserves for losses of its junk portfolio.

This practice falsely inflated the value of the Drexel junk portfolio which was First Executive's largest single asset. In turn, this gave investors and policyholders a false and fraudulent portrait of the health of the insurer and of the safety and security of their investments.

- Purposefully, over many years, refusing to carry Drexel junk bonds at their real values even when required to do so by usual accounting standards. That is, the applicable standard for carrying values of bonds in insurance company portfolios is that if they are intended to be held for sale, they should be carried at the lower of cost or market price. If they are intended to be held to maturity, they are to be held at cost unless an event has occurred to affect price in a way that is more than temporary.

First Executive was by claim and in fact, an extremely active trader of bonds. In 1989 alone, for example, First Executive sold more than $1 billion of securities, mostly bonds, through Drexel Burnham Lambert alone. Fred Carr is on the record as saying that First Executive will actively buy and sell bonds for and from its portfolio.

This might have mandated that First Executive carry its bonds at market, apart from any other considerations.

But even if First Executive truly intended to hold most of its bonds to maturity, it was required to carry bonds with a permanent or apparently permanent impairment of payment ability at market.

That is, if a bond is fluctuating in price because of national or world changes in interest rates, it would be perfectly fair to carry such a bond, intended to be held to maturity, at cost. But if the issuer of the bond is in default or in reorganization, carrying the bond at cost becomes extremely questionable (unless a reserve has been established for default).

Nevertheless, Carr and the top management of First Executive carried at cost or 99 per cent of par bonds of such issuers as Imperial Savings & Loan, Griffin Resorts, Southmark, and Integrated Resources (among many others) even though those companies were either in default or in reorganization or both. Obviously, those bonds were not priced in the market at even close to par. By any reasonable standard, they should have been carried at market or had a substantial reserve for default. There is no evidence of either in any thoroughgoing way.

By such false statements of the carrying values of the bonds in its portfolio, Carr and the top management of First Executive defrauded investors and policyholders as to the true value of the assets in the First Executive portfolio, as to the true financial condition of the company, and as to the security of their investments.

- Deceptively using promissory notes from the parent company to the subsidiaries to make up mandated capital for the subsidiaries. This was especially deceptive because the subsidiaries needed additional capital because they were deemed to be nearing regulatory peril and unsafe condition, thus rendering them of questionable value. Yet the parent company's primary assets were its stock in its subsidiaries. Thus the I.O.U. of the parent company might be deemed to be of slight value indeed if the parent's primary assets were impaired. Yet, in 1908, as noted by an extremely well regarded insurance analyst, Joseph Belthi, First Executive was using I.O.U.'s from the parent in the rough amount of $700 million to supposedly shore up the subsidiaries capital position.

This might be analogized to adding to the length of a blanket by cutting off the top and sewing it to the bottom. It might also be analogized to using a check from an account that is overdrawn to cover a bounced check on the same account.

By this artifice, First Executive deceived investors and policyholders both current and prospective as to its financial health, thus subjecting them to the extremely high likelihood of loss.

- As an ongoing matter, floating new issues of preferred stock to obtain funds to pay the dividends on the already issued preferred stock, which is the explicit manner of operation of a Ponzi scheme. By so doing, Carr and the other top executives of First Executive gave the impression of far greater financial strength and security within First Executive than was in fact the case. This misled investors and policyholders into believing that investments in First Executive were not as dangerous as they in fact were.

All of the foregoing artifices and frauds made it possible for First Executive to give the false impression that it was a successful, solvent, financially sound insurer, rather than the inherently doomed entity that it was. By giving that impression, First Executive, with the help of the criminal Milken Brothers, the legions of accountants and lawyers in their pay, and others, kept the fraud of First Executive going for many years. By so doing, they continued to take in large sums of policyholders' money. Carr and his associates used this money in very large part to continue to buy very large amounts of Drexel issues.

This activity, amounting to over $2.3 billion in purchases from Drexel in 1989 alone when the company was in an advanced state of collapse, continued to harm the interests of the investors and policyholders.

At the same time, it greatly enriched the principals of Drexel Burnham Lambert, especially the Milken Brothers. This was because of the uniquely high underwriting fees charged by Drexel Burnham Lambert for selling its inherently unsafe and unsound bonds. It is an axiom of finance that it costs more to sell a highly questionable bond than a safe one. Underwriting fees for riskless Treasury bonds are essentially nil or else close to nil. For the bonds of a General Motors or a Westinghouse the underwriting fee would be less than one fourth of one percent. Drexel charged a stated four per cent for most of its issues and an additional charge in various other ways which could raise underwriting fees well above ten per cent.

(The staggering size of these fees was what made the sale of Drexel junk so lucrative among other things. That, in turn, is why it was so vital to the Milken Brothers and to Drexel that Carr use his policyholders money to buy Drexel bonds.)

Still other unethical and fraudulent acts by the top management of First Executive which foreseeably harmed the investors and policyholders of First Executive included, among many others:

- Entering into partnership agreements with the Milken Brothers and other participants in Drexel to buy and/or start reinsurance affiliates. These affiliates, owned usually roughly half by First Executive and half by the Milkens and their partners, were purportedly started to reinsure the exposure of the major First Executive subsidiaries.

Like all reinsurers, the Carr/Milken entities such as First Stratford and Regency Equities were ostensibly to insure against extraordinary losses by the affiliates dealing directly with policyholders.

However, in the hands of Carr and the Milken Brothers, First Stratford and Regency Equities acted in ways which made that mission difficult if not impossible. A reinsurer by definition is supposed to have assets which will be secure and available if the assets of the primary insurer fail.

But First Stratford and Regency equities carried as assets primarily still more inherently unsuitable because of the high rate of default) junk bonds issued by Drexel Burnham Lambert. Thus, in the event that the assets of First Executive failed—as they did—the assets of the reinsurers, being of exactly the same kind, would fail as well.

There would be no added protection for policyholders and investors, but there would be further opportunities for gain for Drexel and its associates as the reinsurers became vehicles to buy still more junk bonds.

In this way, Carr and top First Executive management continued to put their own interests first while inevitably harming the policyholders and stockholders of First Executive and its subsidiaries.

- Entering into sham agreements to sell large portions of its most distressed junk bond Portfolio in 1989 to a series of shell corporations in return for "guaranteed" obligations to pay for those bonds. These sham agreements involved an attempt to fraudulently convert about $750 million of highly distressed junk bonds into "investment grade" debt.

This operation can have had as its purpose only the window dressing of the First Executive balance sheet so that First Executive would appear to be more successful and financially sound than it was. In turn, this-would allow Carr to continue to operate First Executive still longer and to continue to aid and abet the Milken Brothers in their sales of very lucrative for them) junk bonds. At the same time, it would foreseeably harm the persons for whom Carr was a fiduciary.

- Attempting in 1989 to effect a highly questionable "sale" of the large New York subsidiary of First Executive to a partnership known as WW Acquisition, made up mostly of a former executive of Equitable Life also now suffering from poorly chosen investments) named Leo Walsh anda long time Milken associate known as Martin Wygod.

This "purchase," which had many questionable elements from its announcement, and which was not completed, had the effect of making the New York subsidiary of First Executive seem more attractive than it in fact was, make the parent therefore seem more secure and financially stable than it was, and fraudulently encourage reliance by investors and policyholders in the First executive scheme.

In turn, this allowed First Executive to continue to operate, to bring in more policyholder money, while simultaneously using that money to buy more junk bonds from Drexel and the Milken Brothers, and therefore enrich them while foreseeably jeopardizing the policyholders and investors in First Executive.

- Entering into agreements—basically with themselves—to take money desperately needed for policyholder claims and give that money to themselves (to Carr and his top lieutenants) in the form of multi-million dollar "golden parachutes" which would be paid even though First Executive had collapsed and defaulted on its obligations to policyholders as the foreseeable result of Carr's own actions. Carr and his confederates went so far as to move cash from entities within California to ones outside California so that the money in question would be "safe" for Carr et al. from the control of California regulators and claimants.

While these agreements were suspended or voided, their existence shows the self-dealing contempt for investors and policyholders which has characterized Carr's behavior and that of his colleagues throughout this tragic drama of aggressive greed and fraud versus the ordinary citizen.

Taken together, the fraud, self-dealing, and incompetence of Carr and his top lieutenants make clear several pertinent points:

- Probably First Executive was a Ponzi from almost its inception under Carr, created to enrich Carr and his colleagues and henchmen and controllers at Drexel, while at the same time foreseeably harming the investors and policyholders of First Executive;
- Certainly in its operation, First Executive operated for the sole benefit of Carr, the Milken Brothers, and others, as a vast receptacle for junk bonds, while at the same time foreseeably failing to provide the insurance coverage it had promised;
- The Carr/Milken operation of First Executive, with all of its fraudulent, foreseeably harmful aspects for investors and policyholders constitutes one of the largest and cruelest frauds against Americans by Americans in financial history. In its impact at the most delicate area of the expectations and needs of survivors and retirees, the First Executive swindle may be the cruelest fraud ever.
- Aggressive federal and state investigation of the misconduct of Carr, the Milken Brothers, and others is warranted, and if the results merit such, civil and/or criminal action against the responsible parties is in order;
- The intent of the federal pension guarantee program should not be allowed to be subverted by resort by bureaucrats to technicalities. That is, pensioners should not be deprived of federal pension guarantees by actions of third persons allied with Carr or others such as changing pension plans into annuities. If the PBGC does not step in to safeguard pensioners it would mean that the protections of federal law can be involuntarily taken from private citizens by other private citizens without any action at all by the victims. This would be a thorough outrage;
- There should be federal minimum standards for insurance company assets and accounting. This is a complex area, but it is clear that the crazy quilt patchwork of state regulation has not worked well. It is also painfully clear that at least to some extent, the regulators of some states, and their national organization, the National Association of Insurance Commissioners, failed to act responsibly even under existing law. There is also at least some evidence that the NAIC was co-opted by Drexel perks in such a way as to create conflicts of interest for those reviewing the credit-worthiness of Drexel issues.

May I add that in general outline, although to a reduced extent, much of what I have said about First Executive is also true about First Capital. I must add, however, that I am not as familiar with that entity as I am with First Executive, and that I have a higher opinion of First Capital's management than I do of that of First Executive.

Thank you for allowing me to produce these thoughts and comments.

Senator BRYAN. Thank you very much, Mr. Stein.

Mr. Baum, nice to have you back with us again, sir.

STATEMENT OF RICHARD BAUM, CHIEF DEPUTY, OPERATIONS, CALIFORNIA DEPARTMENT OF INSURANCE, SACRAMENTO, CA

Mr. **BAUM.** Mr. Chairman, I am Richard Baum, Chief Deputy for Operations of the California Department of Insurance, and I am happy to be here again.

I appeared before you, as just indicated, on May 7 with Commissioner John Garamendi. On that occasion we addressed our seizure of Executive Life Insurance Co. A week later, on May 14, we took similar action with respect to First Capital Insurance Co., the focus of your concern today.

Leading up to the First Capital conservatorship, we had issued on May 10 a cease-and-desist order finding that the company was in hazardous condition and prohibiting policy redemptions and loans. We issued this order in response to a precipitous increase in redemption demands prompted in part by press reports that our department was seeking needed help for the company from American Express and Shearson Lehman Brothers.

Shearson Lehman is a subsidiary of American Express and owns 28 percent of First Capital Life's parent, First Capital Holdings. In turn, First Capital Holdings owns all of First Capital Life. To complicate matters, a syndicate led by Citibank lent $275 million to First Capital Holdings, the life insurance company's parent. After we issued the cease-and-desist order, Citibank applied to a Federal court to force First Capital Holdings Corp. into involuntary bankruptcy.

To protect First Capital Life's assets from becoming involved in the bankruptcy proceeding, we conserved First Capital Life. As you know, the State of Virginia did much the same thing with an affiliated company, Fidelity Bankers Life Insurance. In sum, Mr. Chairman, we issued a cease-and-desist order to stop a run on the policies and ultimately move for conservatorship to protect the company from the holding company's possible bankruptcy which, in fact, has occurred.

While both Executive Life and First Capital invested heavily in noninvestment grade securities, junk bonds, the two situations are quite different. First Capital bonds are of a higher quality than ELIC's in that they are yielding a more consistent income. And First Capital is less reliant upon the junk bonds which comprise 46 percent versus the 60 percent of Executive Life.

More importantly, First Capital's parent company, along with its board and key shareholders and creditors, to date are cooperating in a joint effort with us to rehabilitate the company. We are optimistic about the long-run prospects. By way of comparison, I would note that First Capital is roughly one-half the size of Executive Life, with assets of $4.5 billion, 190,000 life insurance policyholders, and 71,000 annuitants in the 49 States.

I would be happy to answer any questions you may have.

Senator **BRYAN.** Thank you very much, Mr. Baum. Maybe we can get a little more of an update in terms of where you are with Fidelity Bankers. Your assessment seems a bit sanguine that you think that things are going to work themselves out. I do not want to put words in your mouth, but is that, in essence, your assessment of the situation right now with respect to Fidelity Bankers?

Mr. **BAUM**. Yes, sir. We think we acted quick enough in this case by being appointed receiver. We have now been in the company for—this is the ninth day. And we think this company has $2 billion in cash, cash equivalents, Government securities. This was not a case, in our particular instance, of a high default rate of the junk bonds. We were concerned once the pace got up to $25 million a day in surrender requests. We did not want to find all of the cash and cash equivalents and other liquid assets leaving the company. So, in our determination, we were best off taking quick action in order to avoid what would become a financially hazardous condition to both policyholders and creditors.

Senator **BRYAN**. What percentage of junk bonds does the portfolio consist of? We have heard various numbers ranging in the magnitude of 40 percent.

Mr. **FOSTER**. The 40 percent is correct, if the baseis the total bond portfolio; in other words 40 percent of the bond portfolios, is noninvestment grade or "junk" bonds. Other numbers you will hear: 37 percent is correct as a percentage of total asset base.

Senator **BRYAN**. As Mr. Stein made the reference, the NAIC had a different classification system from the rating houses. And yet recently the NAIC changed its classification system. I am a bit confused.

Does the new classification system that NAIC is proposing, does it track with the rating companies in general or is it dissimilar? And if so, in what respect?

Mr. **FOSTER**. To give an example, this company here alone had approximately $450 million in double B rated bonds. Overnight they went from being investment-grade to noninvestment grade. The NAIC, before, had a yes-and-no type of rating. These double B bonds, to use Standard & Poors rating for the moment, were noninvestment grade.

By the change made in June 1990 that the companies put into effect with their annual statement filing in the early part of this year, in our particular company's case, the percentage went from 18 percent of the total assets that were classified as junk bonds to double that, or 37 percent.

So, now the way it is set up it does mirror, for the most part, the rating agencies.

Senator **BRYAN**. Mr. Foster, can you give us some period of time in which you can forecast when, assuming a scenario that you outlined, we might work our way through the process and people could breathe a little easier? Is there time benchmarks that you have established yourself—90 days, 6 months, a year?

Give us some time indication, if you would.

Mr. **FOSTER**. We have talked to the experts that we have assembled and we are confident that within 90 days we will be in a position to assess various alternatives. One could be infusion of capital into the company. Another would be the sale of the entire company to a new buyer. Another option could be selling off certain blocks of business.

We think it will take us probably 90 days to get our arms around the company, to stabilize the company. We are still paying periodic annuity benefits. We have not cut back on those. We are paying death claims. We are paying accident and sickness claims.

We simply placed a moratorium on surrenders. And we felt like we had to do that. We have learned that some of the brokerage houses that were marketing these products had sent letters out to their brokers suggesting clients surrender these policies. This and all the publicity that was being given to First Executive Life and then with respect to reference under the First Capital Holding Co. publicity to Fidelity Bankers being an affiliate company of a California insurer led to a significant increase.

And we felt like we could not sit back seeing a tenfold increase in surrenders and allow this to go any longer. We had serious concerns it could affect the liquidity situation of the company. We wanted to maintain the liquidity. We now have approximately $2 of $4 billion in assets that are, in fact, liquid. And we wanted to preserve the status of the company in that regard.

Senator BRYAN. You mentioned just a moment ago and in your testimony that you engaged an actuarial firm. Is it Milliman and Robertson? Am I pronouncing that correctly?

Mr. FOSTER. Robertson. Yes, sir.

Senator BRYAN. And that they had been involved in doing a valuation.

And I must say and perhaps this bears at least in point indirectly with Mr. Stein's observation, that name has come to our attention in the context that they are the ones who did the valuation for Executive Life and in which the NAIC seemingly relied on in issuing its very scathing condemnation of the action taken by New Jersey's Insurance Commission in December of last year.

As you may recall, Mr. Foster, in that resolution of condemnation, there is a reference made that Executive Life was in no imminent danger and that everything seemed to be fine, that the actions taken by the New Jersey commissioner in requesting the additional $500 million of capital with respect to New Jersey was unwarranted, arbitrary. And that is not the identical quotes. But that is the essence of it.

Yet, we are dealing with this same company. Give us some indication of your comfort level in terms of the accuracy of their assessment based on what, to us as outsiders, it looks like they missed the mark by a country mile in terms of the accuracy of their valuation at that time in December of last year on Executive Life.

Mr. FOSTER. We directed the company to retain them and under our examination laws that cost is to be borne by the company. In turn, we had our own consulting actuaries, William Mercer, Inc., to review their work and give us a report on the study done by Milliman and Robertson.

And they were in some respects critical of the report and gave us some insights and assisted us in interpreting that report. We did turn to that company at the time because of their experience in doing similar work. This was back now in 1990, the latter part of 1990. In fact, they were engaged the midpart of 1990. And certainly one factor in our suggestion to use that firm was the experience that firm did have in this regard.

I would like to address, if I could, though, the resolution in New Jersey. I was at the NAIC meeting. I do not recall the exact words. I do not have a copy in front of me.

The biggest concern I had at the time and that most commissioners had was that, obviously, if every single State looked after its own policyholders and placed a demand for $.5 billion of assets to be pledged as deposit for one State, that company of $8 billion in assets does not have and did not have $.5 billion to give to each and every State.

Certainly, New Jersey would have liked that at the moment, would liked to have had the money. Certainly every State would like to have it at that point in time when there are troubling signs for a company, additional deposits. But certainly at the time there was no money for that company to give, certainly not of that magnitude, to any one State.

And that was the primary impetus for the resolution.

Senator BRYAN. Mr. Foster, I understand what you are saying. We will have a copy of that resolution dropped off for you.

Not that that should be the center point of this hearing, but I must say what I find defensive and shocking is that there is just some rather sweeping statements. You know, where does the expert opinion of the special committee that the Executive Life companies are in no imminent financial danger based on the information, data, and reports reviewed.

And then they go on to say, now, "Therefore, be it resolved that the NAIC believes that the action taken by the New Jersey Insurance Department is irresponsible and contrary to the best interest of New Jersey policyholders and all policyholders of Executive Life."

I offer this only in the context that one of the questions that we have to address here, Mr. Stein, we will get to him in just a moment, obviously has some very strong views, is how adequate is the State regulatory structure.

Because you get the sense that this is a pretty strong measure to all of you that are part of a collegial association that anybody that is too aggressive, anybody that intervenes aggressively, somebody who has just come back from the Governor's office and gotten a veritable transplant of a Governor, is going to face the condemnation of his or her colleagues.

I do not know the circumstances. I do not even know who the New Jersey insurance commissioner is, but his actions, in hindsight, are not the sort of thing that is going to incur public ire and condemnation. I think everybody is asking where was everybody else at this time.

So, that is the context in which that is asked.

Mr. FOSTER. I understand where you are coming from. I guess the point I would make at that time is what if every State had placed a demand for $500,000 in deposit be sent to the State treasurer of each State, how could the company have complied with that?

Senator BRYAN. Mr. Stein, that might lead into some of your observations. And please let me give you a chance to respond to the line of questioning that I was on with Mr. Foster.

Mr. STEIN. Well what would have happened is that the company would have been seized. It would have become insolvent and it would have been seized, which should have been a couple of years ago.

I was at a hearing in Sacramento. I believe one of the other men at this table was at that hearing, at which almost 2 years ago there were questions about First Executive's solvency. And our erstwhile insurance commissioner, Ms. Roxanne Gillespie, said there was no problem whatsoever with First Executive and there was none foreseen.

The extent to which extremely aggressive and absolutely ruthless employees and lobbyists and statisticians for the Drexel insurance captives were able to control State insurance staffs was startling and astonishing.

The problem with Milliman and Mercer, sir, was not so much their work, which was pretty much a straight calculation which any first-year accounting student, I think, could do. It was that they were given faulty data and faulty assumptions by First Executive. I do not think anyone questions their mathematics. They were given a rate of assumed return on assets, a rate of assumed default, and a rate of need for payoffs based upon actuarial calculations.

The problem was the rate of default. They said assume the worst case, that there might be a 1-percent default rate per year in your junk assets. Well, at that time there was a 10-percent default rate a year. And when First Capital was doing its calculations, they were apparently calculating at the very worst 1 percent of defaults a year in the junk holdings.

There had already been an absolutely unquestionable, unassailable study by a professor at Harvard Business School and now at MIT, that the rate of default was between 3 and 5 percent and that was when the market was fairly strong in junk. The rate in 1990 and 1991 was much closer to 10 percent per annum.

So, it is not Milliman and Mercer's calculators that are broken, it is the assumptions being given to them. And I respectfully suggest that the tricks that these insurance companies use to cover up the real rates of default are endless and really bewildering. And you have to really take the bothersome task of immersing yourself in them to see what they are.

For example, they say a default does not mean it goes to zero, it really means it only goes to 40. This is very questionable. They say, well, if it defaults and we exchange it for equity securities, it is not a default at all even if the equities are worthless. If it is a default and we exchange it for noninterest bearing debt, it is not a default. If it is a default and we take it out of the whole asset category and you do not catch us, then it is not a default. And there are just endless tricks.

And when people are not on the pad from these insurance companies do the calculations, the results are terrifying.

Senator BRYAN. Mr. Stein, you suggested among other things that it is shameless and shocking that these people that were involved in these frauds are allowed to live in this incredible luxury, where those who have done nothing for which they could be faulted have their pension benefit plans at risk if some worst-case situations develop. You favor aggressive prosecution. I do not know of anybody that could quarrel with that proposition. I certainly agree with it.

Specifically, what should we do. You are indicating that there was a failure, a breakdown—I mean, all kinds of folks compromised by reason of trips and lavish arrangements. Specifically, what do we need to look at in terms of correcting the problem so it will not occur again?

Mr. STEIN. I think what we need to do, first of all, is have a clear understanding of what happened. That is, we had an enormous operation selling in large part fraudulent debt to insurance companies which then failed to disclose to stockholders, bondholders, or policyholders what they were. I think that some of the people who did that should be questioned and, if warranted, subject to prosecution. I think that is especially true on the Drexel side.

To me, the spectacle of people who are making $100 million a year in income selling junk to insurance companies and federally insured S&L's who have never even been called before grand juries is startling. They knew that they were selling fraudulent instruments to federally insured or State-insured entities. Isn't that a crime?

It seems to me astonishing that people who are employees of the NAIC and were subject to conflict of interest were allowed to do so, and it seems to me whoever allowed them to do so should be questioned, and if fraud was involved, they should be prosecuted.

It is amazing to me, sir, that fraud which involves billions of dollars does not seem to involve any criminal prosecution. I mean, when people rob 7–11's, they are prosecuted. If a trustee of an orphan steals from the orphan's trust, he is prosecuted.

I do not understand how these guys have escaped prosecution. How can it be that there was a fraud involving billions, probably tens of billions of dollars altogether, and there are only two people in jail?

Senator BRYAN. We agree, and we have had discussions with the Attorney General and others in the Justice Department asking many of those same questions.

Specifically, Mr. Stein, in terms of the structure, prospectively, looking at how we ought to look at a more effective regulatory structure in the future, after we comprehend fully the nature of how this all developed, what changes would you recommend to us?

Mr. STEIN. Well, I think there should be a limit on the amount of various classifications of assets that insurance companies are allowed to hold, insurance companies who sell nationally, that the asset classification should be standardized and uniform, and that people who violate these standards and violate standards of disclosure about their assets should be subject to penalties, and I think there should be standards of full disclosure and antifraud, such as there supposedly are in stocks and bond sales.

Senator BRYAN. Mr. Weiss offered full disclosure as one of the recommendations that he would commend to our attention when he testified, analogizing it to a sales security, that disclosure ought to be made and the prospective purchaser given the opportunity to make the decision for himself or herself. Are you suggesting something along those lines?

Mr. STEIN. If the disclosure is extremely forthcoming, yes. It should be able to be understood by the layman and must be explained by the agent, but also, it seems to me, no matter what certain kinds of assets should not be allowed to be held except in the most minimal amounts, or maybe not at all, by insurance companies.

I have a real question, frankly, as to why insurance companies should be able to hold junk assets at all. There are plenty of perfectly good assets they could hold, and I would defy anyone to find an insurance company which went broke because it was holding too many treasuries.

Senator BRYAN. Mr. Baum, you are on the firing line. I think it is fair to acknowledge publicly that you have just come into the arena.

Mr. BAUM. I want to correct, I was not at that hearing that occurred 2 years ago.

Senator BRYAN. Mr. Baum, why do you not share with us an update as to where you are with First Capital out your way?

Mr. BAUM. The First Capital situation, as I really was trying to focus in my testimony, is, from our perspective, being in the midst of Executive Life, now, and First Capital, a different situation. Our move on First Capital was really most closely like a run on a bank. We had a situation where within a 2-week period surrenders had moved from a $10 million average to $100 million the day before we issued the cease-and-desist order, so our effort, really, there was to preserve the liquidity and to be certain that we in effect were able to stabilize the situation.

Unlike First Executive, or Executive Life, where we in fact knew we had severe asset issues and as a result, as you know, went to 70 percent on the annuities alone. We felt comfortable enough in looking at the situation to continue at 100 percent the annuities as well as the death benefits, and only, as the Virginia commissioner did, put a moratorium on surrenders.

We feel every strongly that there is a responsibility on the part of the shareholders of First Capital to assist in the cure of the problem. American Express and Shearson Lehman, as noted earlier, owns 28 percent of the holding company, 75 percent of First Capital's business was produced by Shearson Lehman, Shearson sold $2.8 billion of the First Capital life policies and annuities.

We have articulated to them our belief that this needs to be a cooperative effort. We are still in discussions with them. So far things have been very cooperative. In addition, we are looking at a series of business plans that we believe will ultimately prove successful in this company.

Senator BRYAN. Let me ask you to look in your crystal ball for a moment. Mr. Foster seems to be reasonably comfortable that you will be able to work it out. Everybody is going to get paid off, and there is going to be no default and, as I understand his testimony, every category of claimant is receiving the benefit of the contractual obligation and rights under those contracts. Do I take it from your comment the same thing exists with respect to First Capital?

Mr. BAUM. That is essentially the same thing. The only caveat I give is that one of the contractual rights is the right to surrender, which of course we placed a moratorium on, but we believe at this point—and again, these things are fluid—that as we move through it, that working within the contractual provisions that exist we will ultimately be able to come out of this with a positive result.

Senator BRYAN. What kind of circumstances might intervene that really would change your analysis?

Mr. BAUM. Massive changes in the securities market. I frankly think that the kinds of things that would be severe to this company are going to be sufficiently severe that we will not just be discussing insurance companies.

Senator BRYAN. In terms of valuing the assets, what value do you place on these junk bonds, some of them, I guess, are still performing in the sense that payments are continuing to be made, as I understand.

Mr. BAUM. Really, in our particular portfolio, using these gradations, the grade 6 being the worst, or what I have euphemistically called at Executive Life the toxic waste of the junk bond industry, Executive Life had about 10 percent in that area. First Capital has about 1 percent. These are bonds that are essentially in default.

The rest are performing, and while I agree with Mr. Stein, in a number of instances they are certainly not the kind of asset we would expect or ultimately want insurance companies to be having, at this point in time we do not see them at significant risk.

Now, the market is in constant flux, so I do not want to be too predictive here.

Senator BRYAN. You are coming in after the fact, but Mr. Stein raises the question that most folks kind of have in mind with life insurance that this is the epitome of stability and security and that really you do not have to worry about your life insurance company, and I think that unfortunately has received quite a jolt in light of what has occurred in the last 2 or 3 months, and some other reports that you are all very much familiar with.

How about the basic proposition? Should these companies be allowed to buy noninvestment-grade securities and hold them in their portfolio? Ought there to be prohibitions against that?

Mr. BAUM. I personally believe that the nature of the portfolio that an insurance company holds ought to clearly and comfortably support the nature of the products that it is selling, and in that case, to the extent that the nature of your products require you to take significant risks, and then therefore require you to take the kind of asset base that has inherent in it a risk, is inappropriate. I mean, I would take it down to zero if need be.

Those issues have to do in great part with disclosure. To the extent that someone is investing in a security or a high-risk security, they ought to know about it. I do not think the insurance industry or the purchaser of insurance, at least, until very recently, ever believed he or she was purchasing a high-risk instrument.

So, we have a problem not only with the assets but with the nature of the products, and so we need to control both, and I think if we control the nature of the products we will find that the nature of the assets required to support them is going to be very different and ought to be very different.

Senator BRYAN. Mr. Stein seems to be suggesting, and I presume that he is talking about a uniform national standard, which would limit the portfolio to certain types of assets. Do you think that would be helpful?

Mr. BAUM. Commissioner Garamendi was asked that question yesterday, and probably unsurprisingly I agree with his position on it, and that is that there ought to be a national standard. As to whether that then moves into national regulation, and so forth, I do not think we are convinced of that yet.

The savings and loans and the banks have been under national regulation, so to speak, and the record there is not a whole lot better than the record in the insurance industry, indeed, might be slightly better than insurance at the moment. But the need for standards is absolutely the case, and we believe very strongly in that.

There are other standards, though, that I think are at issue here, and you raised them. The discussion on Milliman and Robertson is a very interesting one and is one that, having dealt with actuaries in another life, it is really true to a certain extent.

Professional firms, particularly those that crank out numbers, are engines, or vehicles, and it is the fuel that you put in or the assumptions that you create that gives you the result, and the question in this process then is at what point does the processor have a standard or a professional responsibility to say, that assumption just does not make sense. We can do it, but for the purpose and the result that is going to come out, you are going to be misleading in this assumption.

We know that in the savings and loan and in the banks, this issue came up with the accounting firms, and I can tell you from my Executive Life experience that it was a lesson learned, because the replacement accounting firm called us several days before they issued their—I think probably the statement that ultimately pulled the plug on the whole thing, which was the 10K, where they did not give a going concern opinion.

When they called us they pointed out the standards of care that they are required to follow in these instances requires them to take a look at what sort of imminent regulatory action might be there, what other sorts of things could be going on.

I think that if we ask our professionals that we are relying on in many ways to give opinions about these things to have that same standard of care, the ability to manipulate I think will be dramatically reduced.

Senator BRYAN. When you are talking about a national standard in terms of minimal standards, are you talking about a Federal statute that would establish a floor or a baseline in terms of standards as it relates to either percentage of asset holdings or other aspects of minimal financial standards?

Mr. BAUM. That is certainly one vehicle. I think that if you had to look at a regulatory model the preference would clearly be something along the lines of OSHA, where a minimum standard is set and if a State wants to exceed that standard it has no problem doing so.

So, the specific standard I am talking about deals with the kind of asset holdings. Again, I want to note that there is a direct correlation between the assets you hold and the kind of products you produce, and, to the extent that American business requires creativity and new sorts of products, this could be restrictive.

To the extent that those products are going out we want them to require in the disclosures, there perhaps they can have a separate thing. But then maybe they are not insurance, maybe they are security item, and they should be governed differently.

Senator BRYAN. Are you satisfied looking at the experience you had with the Executive Life—the relationship between the holding company and the subsidiaries in which there seems to have been—and maybe you could develop that a little bit—in which the holding company seems to have taken certain actions with respect to the asset of the subsidiaries. It just strikes me as being incredible that——

Mr. BAUM. It is not only incredible. It is frightening. One of the methods through which insurance company assets can be manipulated is the whole issue of—as Mr. Foster just pointed out—of upstreaming of money. And of course, one of the first actions that was taken by our Commissioner Garamendi was to put an order out—this was before the conservation which essentially prohibited any movement of any money from outside of the life insurance company itself. Absent that kind of scrutiny, there are a variety of ways. And as you know from the situation with Mr. Carr's pension, there were multiple subsidiaries—money moved around—and there needs to really be a more vigorous fluoroscope approach taken to the relationships between subsidiaries and the parents and the insurance company.

Another element of that is the reinsurance system where there is a great potential for abuse with internal reinsurance. You end up having an opportunity to do new business because you have reinsured through a subsidiary that probably could not have done business itself. So, these are the things we are trying to come at and I think the best vehicle for it is an aggressive attack on the structures as well as the statements of the companies.

I think historically the method of regulation has been one of, once the company came into existence and was certified to do business, was a review annually—in most cases or if you had a triennial examination—but annually through the reporting process of the balance sheets and the financial statements. What clearly needs to be done is to go into the company and look at the structure as well. And we are doing more and more of that as companies want to do mergers or want to purchase other companies. You really have to look at the relationships.

Senator BRYAN. Mr. Foster, you are still on the firing line as an insurance commissioner. There are some in the insurance industry which I think represent a sea change in attitude or a saying, look, we have always favored regulation being handled exclusively at the State level. And although they may not be prepared to go so far as to say we ought to preempt it, they are saying pretty much what Mr. Stein is saying in part that there are—and Mr. Baum as well—that there are some national standards that have to be met, and that it requires Federal regulation to establish those in terms of uniformity across the country. And they specifically mentioned the two areas Mr. Baum mentioned. That is the reinsurance problem, but that may be beyond the capability of even the most well-intentioned, aggressive, effective State regulator at the State level.

I know that may be heresy from the standpoint of a State commissioner's perspective, but let me have your own if I may.

Mr. FOSTER. I think the States need to look to the areas where perhaps some Federal and national standards would, in fact, be helpful. I do not sense in my colleagues an attitude that we are saying the States are regulating perfectly the business of insurance in this country. We recognize for example—take the area of fraud—we have made a recommendation that if the Federal Government wants to be involved in assisting the States, that is the first place they could start. We need help in that area.

Talk about holding companies, we end up with many of our domestics domiciled in one State. There might be—the corporation chartered in another State. The holding company is in a third State. It is very, very difficult frankly for an insurance commissioner to convince an attorney general of one State to spend the resources and time—even if it is possible—to go after some of the people who are involved in some of these cases of fraud.

So, the NAIC has suggested this as an area the Federal Government could be of help in. We need your help in that regard. Likewise, we suggest in the area of alien insurers, both reinsurance companies and direct writers that the time has probably come to have a national clearing house for companies. And when we say alien, we mean outside of the United States. And we have suggested that the Congress could look to the NAIC—the NAIC would have to be empowered to do that. The NAIC cannot do it now. The NAIC does have an office that assists the States in looking at and approving a given list of surplus lines companies which are alien surplus lines companies.

So, those are two areas already recognized where perhaps there ought to be some involvement on the part of the Federal Government. I do think when we talk about national standards, I am not ready to give up yet on the NAIC and the role it can play in an association of the 55 insurance regulators.

You asked a minute ago about the question of junk bond holdings and should there be a national standard. I think there should be a national standard as to all investment laws that govern insurance company investments. The NAIC is working on that and hopes to have a model investment law that will become part of our accreditation package by the end of this year.

I think that needs very careful study and review. Frankly, in many respects it is easy now to say, let us not allow any insurance company to invest anymore in junk bonds. But have we considered the effect of saying that unless you have got a triple B rating that insurance companies can no longer invest in those kind of corporate obligations. That is suggesting everything below a triple B as established by Standard and Poor's is in fact a bad investment.

My suggestion would be let us look at that very carefully and know the effect both on the insurance industry, on the pricing of those products, and certainly there has been many indications of products and pricing being, if you will, reckless. But I am not sure the response to that would be to go across the board and say—at least at this point in time it is not fair to say—that no insurance company should buy any bond with a rating of less than triple B.

But I do think national standards are in order. And under the current arrangement at NAIC, there are limitations. NAIC cannot force the States to adopt its model acts and model regulations. And that is where I think there will be a role for Congress to play, building upon the best the States have to offer. But there are some areas we need your area, and frankly as one commissioner, I look forward to working with the Congress in trying to fashion some solutions to these problems which do go beyond State boundaries.

There is not a question; we have got here a California company and a Virginia company owned by the same California holding company. We have worked together—the two States—but this certainly goes beyond State lines and we need to recognize that.

Senator BRYAN. Mr. Stein, what is your response? Mr. Foster was saying perhaps we ought not move too quickly in saying on noninvestment grade securities holdings by insurance companies that there ought to be some kind of a national standard. Is he being too cautious from your point of view?

Mr. STEIN. Well, from my point of view, he is, sir. It seems to me if he were to go to the ordinary citizen who has worked hard and wants to ensure his retirement or his survivors' comfort and say to him, "Look, do you want to buy bonds from these guys," and then see the Drexel guys and hear some stories about the Drexel guys. Do you want your retirement to be contingent upon whether or not these bonds turn out to be good? I do not think anybody in the world in his right mind would say "Yes." These insurance policies were sold as something else. They were sold as solid investments based on solid bonds.

I have read many, many, many First Executive annual reports and a number from First Capital Holdings. None of them even give a clue that what they are really selling is a portfolio of junk bonds. You get the impression, especially with the First Capital annual reports, that you are buying something which has the giant, cheerful blue hand of American Express backing it up and that it is as solid, as you might say, the Rock of Gibraltar.

And if you were to say instead what you are going to have as the product of a whole bunch of guys yelling and screaming out of a telephone boiler room at the corner of Wilshire and Rodeo in Beverly Hills, I do not think anybody would buy it. Let us see some honesty here. Let us see some honesty in what we are selling Mr. and Mrs. America to provide for their retirement.

Senator BRYAN. Mr. Foster, you spent some time talking about the NAIC. Let me ask you a little bit. Your State, for example—I am aware generally that there are some NAIC standards that have been recently promulgated that at least in part purport to be part of a comprehensive package. Your State—how have you come in terms of adopting those new standards in Virginia?

Mr. FOSTER. We are requesting the NAIC to accredit Virginia this year and we will be in full compliance. We went to our legislature and I am pleased to say during the course of the last session there was unanimous support from both sides of the aisle to the package that we laid before the general assembly.

Senator BRYAN. Now there was a report that we received that may be erroneous. And let me give you an opportunity to correct it if we misunderstand it. We have been told that with respect to the requirement for an independent audit by CPA that those provisions of the proposed model, "have not been adopted in Virginia." Is that correct or are we——

Mr. FOSTER. The accreditation team will come in late this year. The hearing is set to adopt that in June of this year. I do not know who got that information. But if you ask me as of today is it on the books, the answer is clearly, "No." We do have due process requirements. It has been set for hearing. We take comments and expect to adopt it this summer.

Senator BRYAN. Mr. Foster, I am not sure that I am following your response. My understanding is that the NAIC model proposal requires an independent audit by a CPA. Am I correct on that?

Mr. FOSTER. Do you mean as to each company's annual statement?

Senator BRYAN. Yes.

Mr. FOSTER. Yes, sir.

Senator BRYAN. And if that is correct, and you are confirming that it is, we had received information—it may be erroneous—it would not be the first time that it had happened here in Washington—but we had received information that indeed the Virginia statute did not embrace that specific provision requiring the independent annual audit by a CPA.

Mr. FOSTER. That is correct. It does not belong in the statute. The commission has the authority and has taken that authority and has set a hearing. We have drafted a regulation. It will be adopted in a regulation of the State corporation commission under the general authority of one of our statutes. But we did not put that in the statute. That is correct.

Senator BRYAN. You seem to have no objection, per se, with the requirement, if I understand your testimony. But yet, you are saying it is inappropriate to put in a statute, if we are talking about a national standard of accountability, if you will in terms of the sorts of things that will protect the public.

I mean the independent audit by a CPA strikes me as being pretty central to getting, both from the standpoint of the regulator and the general public, an honest assessment of what the financial condition of that company is. From the standpoint of the layman, I cannot think of anything that would be more appropriate to put on the statute. Let me get the benefit of your thinking.

Mr. FOSTER. There are many, many areas of very serious regulatory concerns that the State corporation commission does not go to the legislature in each one of those cases and say, "Put this on the books." We go to them and get the authority we need to draft, and promulgate, and adopt regulations that carry out the statutes on the books. We already have on our books, a clear statute that gives us every authority to require CPA annual statements.

For us to go back to the same general assembly and say, "In spite of that, we want a separate statute," would provide no more force and effect of the requirement. By doing it according to regulation, frankly, it makes it easier for us to strengthen it, to amend it in the future. We do not have to wait until January of each year.

We can amend the regulation with 30 days notice anytime in the future when we want to strengthen the regulation. So in many regards, it gives us more flexibility by adopting it by regulation than by statute.

Senator **BRYAN**. There is no question that it gives you more flexibility, and I do not mean to be contentious with you personally. But there are those who would look at what happened in California, before Mr. Garamendi's term on the block so to speak, who would say, in effect, that there was inaction, that there were requests. Mr. Stein made reference to it, certainly in the article which I have read that he did recently, that there were requests by many. And there are others of your fellow commissioners who have come and said, look, we tried to get California to take more aggressive with respect to Executive Life.

Not every insurance commissioner is going to be as aggressive and forceful as, perhaps, you are, Mr. Foster, on this particular issue. That same flexibility that gives you the ability to shape and to perhaps fine tune what kind of independent audit you are going to require also gives that commissioner who, harking back to Mr. Stein's comment earlier, gives that individual an opportunity to say, "Look, we are not going to require it." And frankly, I think if that is a domiciliary State, that really presents problems for all of you, does it not?

Mr. **FOSTER**. Senator, with all due respect, I think you do not fully comprehend our regulatory scheme in Virginia.

Senator **BRYAN**. And that is certainly probably true.

Mr. **FOSTER**. Our State corporation commission is a court of record in Virginia. Its decisions are only appealable to the highest court in the land, the State supreme court. Steven T. Foster, Commissioner of Insurance, can do nothing to tamper with the regulations of the State corporation commission, either to make them more restrictive or less restrictive.

I have to go to that full court of record in a public hearing. I do not preside. I am there, if you will, as a party along with other participants; the attorney general's office, the industry. Once a regulation is on the books of the State corporation commission, I cannot tamper with it unless I go back into a full, public hearing before those same three individuals and argue why, because there is some pressure on me, I want to, in someway, undo what the commission did.

We do that, frankly, because we do not want to go to the general assembly every single year on a once a year basis and put in the statutes things that we clearly can do without the general assembly in session. And so, I hope you do not think that we chose deliberately to do it by regulation as opposed to statute and interpret that as some indication that we are less committed to having CPA audits. And I would hope that no other State would view it that way.

But our system, frankly, is different in Virginia. We are a fourth branch of government. We are not part of the executive branch. The commission regulates, not only insurance, but securities, banks, railroads, trucking, and they have got very clearly prescribed rules of the court. And we cannot change regulations. I cannot without going through a very formal and rigid process.

Senator **BRYAN**. And I appreciate that explanation and that is helpful. You recognize, having dealt with all of your colleagues, that that system certainly is not the pattern.

Mr. **FOSTER**. Ours is quite unique, that is correct.

Senator **BRYAN**. I am coming from a frame of reference where you have a single commissioner in many States, some of whom have been, at least in retrospect, less diligent than they ought to have been in light of the circumstances.

Mr. **FOSTER**. My comments are limited to Virginia. I do not know. In other States, it may be more appropriate, given their insurance codes to do that sort of thing by statute.

Senator **BRYAN**. Gentlemen, we have got a vote that is in progress. If we could take a recess for about 10 minutes and then we will continue. Mr. Stein, if you have got a plane that you have got to catch or a commitment, we will understand. We will visit a little bit more.

Let me get your attention here for a moment. I have been informed that we have got a series of votes that is going to take some period of time. Let me just keep the committee hearing record open and I would request your courtesy in responding to any questions that may come from members of the committee.

Thank you, gentlemen, for being here. But this is not something that lends itself to coming back every 5 minutes as we go through these series of votes. In light of that development, we will declare this hearing adjourned.

And I thank you, Mr. Stein, Mr. Foster, and Mr. Baum for your testimony.

[Whereupon, at 4:14 p.m., the committee adjourned.]

APPENDIX

PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

I. INTRODUCTION

Mr. Chairman, members of the committee, my name is Bill McCartney. I am Vice President of the National Association of Insurance Commissioners and the Director of Insurance for the State of Nebraska. I have been my State's Insurance Director for the last four years. The NAIC is an association of the chief insurance regulators from the 50 States, the District of Columbia, Guam, American Samoa, Puerto Rico, and the Virgin Islands. The NAIC thanks you for this opportunity to discuss with you the important topic of the regulation of insurance companies for solvency.

First, I will present a brief overview of the 120-year history of State solvency regulation. Second, I will describe the significant improvement the NAIC and State insurance regulators have made in recent years to the solvency regulation system. Finally, I will outline a few of the issues we will be addressing in 1991. By presenting my testimony in this fashion, I hope to provide a background which will help you better understand the current state of insurance solvency regulation.

II. THE NAIC'S 120-YEAR LEGACY OF SOLVENCY REGULATION

The NAIC's involvement in solvency regulation dates back to its formation 120 years ago. In fact, the NAIC was created specifically to address a spate of insurance company insolvencies in the late 1860's and early 1870's. Since then this Nation's State regulators have worked together, through the NAIC, to protect the American consumer from the financial and personal loss that can be the result of the insolvency of an insurance company. The resulting system of insurance regulation provides a high degree of uniformity in the supervision of interstate companies, yet is sufficiently decentralized to provide responsiveness to insurance consumers and a sensitivity to the regulatory needs of a diverse Nation.

The history of the NAIC's involvement is one of innovation and adaptiveness in the regulation of an industry that has undergone dramatic changes in the past century. In 1875, the NAIC adopted the predecessor to the annual statement blank which, since then, has served as the uniform financial reporting form for all insurance companies. Thirty-four years later, when changing and sometimes fraudulent investment practices by insurers threatened the stability of the industry, the NAIC established the Securities Valuation Office (SVO) to provide uniform valuations of insurers' securities.

In the 1930's and 1940's, multi-State insurance companies became more prevalent. The NAIC responded, first by establishing the "zone examination system" for the regional examination of multi-State companies, then by publishing the NAIC Examiners Handbook, to standardize zone examination procedures.

During the 1960's and 1970's, as the business of insurancecontinued to grow more complex, the NAIC responded with a host of improvements in solvency regulation. These enhancements included the adoption of model guaranty association acts and the institution of a centralized data base and early warning system to help identify and prioritize troubled companies. This system was later expanded to become what is now known as the Insurance Regulatory Information System (IRIS). Further standardization of solvency regulation was achieved with the release of the statutory accounting manuals for life and property/casualty companies and the Troubled Companies Handbook.

III. RECENT DEVELOPMENTS IN SOLVENCY REGULATION

History no doubt will view 1988 as a watershed year in solvency regulation. That year, 31 multi-State insurers became insolvent, the largest number in several decades. Far more disturbing was the upheaval in other financial services institutions, primarily regulated by the federal government. The number of bank failures continued to climb, from 184 in 1987 to 200 in 1988. That year the 223 failed thrifts totalled nearly four times the failures in the previous year.

A. Financial Regulation Standards

In this environment, in which troubles in the federally regulated financial institutions has shaken consumer confidence in all financial institutions, the NAIC has moved aggressively to address regulatory concerns in the world of insurance, by beginning the process which led to the 1989 adoption of the financial regulation standards. These minimum standards establish bottom-line requirements for State solvency regulation in three key areas:

(1) laws and regulations,
(2) regulatory practices and procedures, and
(3) organizational and personnel practices.

In order to provide guidance to the States regarding the minimum standards and an incentive to put them in place, the NAIC adopted in June 1990 a formal certification program. Under this plan, each State's insurance department will be reviewed by an independent review team whose job it is to assess that department's compliance with the NAIC's financial regulation standards. Departments meeting the NAIC Standards will be publicly acknowledged, while departments not in compliance will be given guidance by the NAIC on how to bring the department into compliance. Furthermore, beginning in January 1994, accredited States will not accept reports of examination from unaccredited States, providing further impetus for States to adopt the minimum standards. We fully expect that, in the next couple of years, accredited States will enact additional provisions in other areas of regulation, providing for even greater inducements for States to become accredited. As a result, not being domiciled in an accredited State will increasingly become a liability, inducing States to meet the standards or witness the redomestication of their companies. So far, two States, Florida and New York, have been accredited under this nascent program, and we expect that others will be accredited in 1991. It should be noted that the initial audits were conducted in two States recognized as having well equipped solvency regulatory capabilities. In addition to verifying the capabilities of these departments, much was learned about the audit procedures required to obtain a thorough, credible assessment of solvency regulatory resources, which lessons will be incorporated into the upcoming audits.

Some critics of State regulation have questioned whether the States will respond to the NAIC's call for enhanced solvency regulation through passage of the statutes and regulations required for NAIC certification. I am here to report to you that the response in these first few months of the program has been very encouraging. Just last month, the National Conference of State Legislatures and the National Conference of Insurance Legislators adopted resolutions calling on the States to adopt the NAIC's standards in every State, while the National Governors' Association passed a similar resolution endorsing the NAIC's solvency policing agenda and reaffirming the organization's opposition to federal preemption of State solvency regulation.

In the State legislatures, it is still early in the 1991 legislative sessions. So far, however, it appears that the joint call of regulators, legislators, and governors for enhanced solvency regulation is being heard. Across the Nation, State legislatures are moving aggressively toward the implementation of legislation called for by the NAIC financial regulation standards. While we will not know the full success achieved in this cycle of legislative sessions until later this year, I feel confident that 1991 will be marked by the most sweeping enactment of insurance solvency legislation in the history of the country.

The adoption of the financial regulation standards is, however, but one aspect of a broader solvency policing agenda of the NAIC, an agenda which was first adopted in December 1989, then updated last December. The original NAIC solvency policing agenda had five main components:

(1) the financial regulation standards which I have already described;
(2) improved reinsurance evaluation;
(3) more effective financial examinations;
(4) improved solvency analysis support; and
(5) risk-based capital requirements.

B. Improved Reinsurance Regulation

Regulation of reinsurance activity, by which insurers spread their own risk to other companies, is of particular importance to State regulators. In order for an insurance consumer to be confident that his own insurance company can make good on its promises to him, he must be confident that his insurer's reinsurer is willing and able to keep its promises. The regulatory challenge posed by reinsurance is made more complex by the fact that many reinsurers are based overseas, and therefore not subject to the direct regulation of either the State or Federal Government.

Several decades ago, State regulators devised a method of regulating foreign reinsurance companies by regulating the degree to which the primary carrier may reduce liabilities for reinsurance on its balance sheet. In 1984, this concept was codified in the Model Credit for Reinsurance Act, which allows such a reduction of liabilities only if the reinsurer is licensed in the State, is accredited, qualifies under either the so-called Lloyd's or ILU provisions, or establishes either an acceptable trust, letter of credit, or cash deposit. Through the direct impact this treatment has upon the balance sheet of the primary carrier (the "ceding insurers"), State regulators can exercise a formidable influence over reinsurers, whether licensed to do business in a State or not.

Perhaps the most dramatic changes in the regulation of reinsurance have come about in the area of reporting requirements. The most notable of these is a new detailed reporting requirement which gives primary carriers a financial incentive to assure that their reinsurance companies pay promptly. Furthermore, by incorporating the rule into the NAIC annual statement blank, it has become a uniform reporting requirement in every State. Finally, the rule allows regulators across the Nation to quantify the extent of overdue reinsurance and identify slow-paying reinsurers.

Another important development in the realm of reporting requirements is the creation of a more refined, computerized NAIC reinsurance data base. Beginning with the 1989 annual statement, all reinsurers are now identified with a unique identification number. As a result, regulators can track the reinsurance operations of all companies in the United States, including reinsurance ceded to virtually any company worldwide, and thus are able to evaluate the ripple effect of potential reinsurance insolvencies upon the rest of the industry. This ability to spot potential land mines that lie in the path of an insurer's financial health will better equip regulators to avoid or minimize solvency problems. Also, regulators are able to quantify reinsurance ceded to alien reinsurers and identify insurers which are highly leveraged by reinsurance transactions.

For some time, American regulators have been concerned about their lack of authority over reinsurance intermediaries and brokers. The potentially dangerous practice by some insurers of turning over critical management decisions to intermediaries, and the resulting improprieties encouraged by this practice, led the NAIC to craft the Reinsurance Intermediary Model Act. This act mandates licensing for brokers and managers of reinsurance, and establishes minimum requirements for the relationship between ceding insurers, intermediaries, and reinsurers.

For similar reasons, the role of managing general agents has come under scrutiny, leading to the September 1989 adoption by the NAIC of the Model Managing General Agents Act. A managing general agents is an agent who either handles the reinsurance contracts for an insurer or manages all or part of its insurance business, and underwrites premiums in the amount of at least 5 percent of the company's net worth. Like the Intermediaries Model, the MGA Act prescribes limitations on the relationship between insurers and MGA's, limitations which are designed to weed out the improprieties that led to the abuse of the MGA function in some of the more conspicuous insolvencies in recent times.

C. More Effective Examinations

Another key component of the NAIC solvency policing agenda for 1990 was an overall assessment of examination processes. Last year, the NAIC adopted a model law on examination at the winter national meeting. This model represents a conceptual change with respect to the frequency and scope of on-site financial examinations of insurers. By authorizing the Commissioner to conduct examinations whenever it is deemed necessary, and no less frequently than every 5 years, it is designed to direct Department resources toward the examination of companies most likely to encounter financial trouble. This conceptual change can be accomplished because of the recent addition of new financial regulatory tools, such as independent CPA audits, opinions on insurance reserves by actuaries, and annual financial statement analyses, among others, which alleviate the need for comprehensive periodic examinations.

Of the various planks of the solvency platform adopted in December 1990, one of the most important was the requirement that insurance company financial statements be subject to an annual audit by a certified public accountant (CPA). This requirement was adopted both as a model regulation and as an amendment to the annual statement Instructions. The significance of the incorporation of the CPA audit requirement into the Instructions is that it takes effect immediately in all 50 States.

At the 1990 winter national meeting, the NAIC also received a report from the Examination Processes Committee which includes 17 recommendations regarding the examination process, including improvements in the Examiners Handbook, an increased focus on computer audit techniques, the creation of an NAIC Education Foundation, upgrading qualifications of financial examiners, and the creation of an NAIC "strike force" of examiners, among others. Last October, the NAIC adopted a multifaceted proposal which requires that actuarial opinions regarding the adequacy of a property/casualty insurer's reserves comment specifically upon items which might materially affect reserves, such as discounting, reinsurance collectibility, financial reinsurance, loss portfolio transfers, and salvage/subrogation. Perhaps as important a change was the requirement that the actuarial opinion address both gross and net reserves, a modification that will give regulators a clearer picture of a company's total potential liability if reinsurance agreements were to fail.

D. Improved Solvency Analysis Support

In recognition of the need to enhance the NAIC's solvency analysis support to the States, the NAIC has bolstered its budget for solvency regulation by $2 million over last year's amount. The NAIC's staff of financial analysts has been increased, and the Potentially Troubled Companies Working Group, the NAIC multi-State peer review committee that tracks insurance department handling of companies that are facing solvency problems, has developed additional computer-based financial solvency analysis system.

E. Risk Based Capital

For nearly four decades, State regulators have utilized a form of risk based capital regulation for stocks and bonds held by insurers. Life and health companies are required to establish reserves for their investments in securities, the size of which are based upon the quality of the assets. For example, a low-grade bond in an insurer's portfolio might require the establishment of a reserve that is twenty times higher than that required for a high-quality bond. Similarly, property-casualty companies may carry high-grade bonds on their books at their amortized value, but must carry their lower-grade bonds at market value.

However, insurance regulators, like their counterparts in the banking regulatory community, realize that a more comprehensive risk-based approach to capital requirements, one that addresses asset risk for all assets, insurance risk, interest rate risk, and business risk, will improve solvency regulation. At the NAIC's winter national meeting last December, the NAIC charged two working groups to develop a model act on risk based capital. The two groups are expected to propose in June 1991 a model act to provide a uniform basis for the treatment of insurers that do not meet the risk-based capital requirements, and to develop formulas and calculations for inclusion in the annual statement blank.

The NAIC also has drafted a Model Investments in Medium Grade and Lower Grade Obligations Act. The model, which we expect to adopt this year, would establish an aggregate cap of 20 percent on medium and lower grade obligations, with a graded system of caps based upon the quality of the obligations. The purpose of this regulation is to allow insurers some flexibility to invest company assets in medium to lower grade bonds, while at the same time assuring that the special risks associated with such bonds are mitigated.

The NAIC is also working on a proposal to conform preferred stock ratings to the same categories used for bonds. The regulators are evaluating the impact of the proposed benchmarks dictating which stocks would be carried at cost and which would be carried at market value, and are expected to develop a proposal for action this year. Additionally, a task force of the NAIC is developing a survey of all insurers to develop a data base of total investments in real estate, mortgages, and other assets with real estate related exposure.

IV. THE 1991 SOLVENCY AGENDA

In December 1990, the NAIC unveiled its solvency agenda for 1991. While ambitious, the agenda is both achievable and necessary to our plan to continue the enhancement of insurance solvency regulation. In addition to the continuation of the solvency activity I have described, we have added a series of new regulatory initiatives to our agenda.

First, we will complete the revision of the Examiners Handbook, incorporating the American Institute of Certified Public Accountants' generally accepted auditing standards tailored where appropriate for the regulatory perspective, and establish a system for annual review of that Handbook. Furthermore, we have plans to increase emphasis and coordination of computer audit techniques.

Second, we are allocating additional resources within the NAIC to assist State insurance departments in interpreting reinsurance contracts and evaluating reinsurance companies. When combined with our recent creation of a reinsurance data base, this will do much to strengthen the ability of regulators to regulate this important sector of the industry.

One of the challenges facing regulators is expanding the pool of financial examiners, auditors, and regulators who have had enough experience to assume the decisionmaking and policysetting responsibilities needed for complex insurance regulatory activities. To that end, we have created a NAIC education fund, and to develop and implement intermediate to higher level training courses for these relatively scarce professionals.

As I have explained, the NAIC is dedicated to improving the system by which regulatory efforts are focused on those companies most in need of close scrutiny. We have pledged ourselves this year to create a centralized financial analysis unit within the NAIC which will refine and improve the IRIS financial ratios so that they continue to be useful to insurance consumers, regulators and others. This unit will also develop a series of computerized analytical routines which can be made available to State insurance departments to enhance their financial analysis resources and capabilities.

We also are developing computerized and other financial analysis techniques so that the NAIC financial analysis unit can perform comprehensive analyses of insurance companies that may be troubled to support the activities of the Potentially Troubled Companies Working Group in its oversight role. Additionally, the NAIC will continue to assist States in developing and improving financial statement analysis capabilities and techniques.

The question of how receiverships are handled will be the subject of NAIC scrutiny this year. We are studying the receivership function and operation in the various States and to make recommendations for improvement if required. This process will begin with a survey of State insurance commissioners to obtain information with respect to their receivership operations.

V. CONCLUSION

Certainly, one of the lessons of the 1980's is that no regulatory system, State or Federal, is perfect. The rapidly changing environment of financial services products has created new challenges for regulators at all levels, in all sectors of the financial industry.

Yet another lesson of the last decade is that the notion that Federal financial regulation is inherently superior to State regulation is groundless. It is no coincidence that the State regulated insurance industry has weathered the economic storms of the last decade in better shape than other sectors of the financial services industry. State insurance regulators have a long history of prudent regulation, regulation which has served the American consumer quite well.

There is no question that insurance solvency regulation can be improved and, in fact, is being improved as I have already described. I am convinced, however, that the best way to improve this system is to build upon its strengths at the State level. While we welcome the attention paid by the Congress to insurance solvency regulation, we urge caution upon the Members of this body as you look for ways to assure your constituents that their insurance companies will fulfill the promises they have made. The system that has well served insurance consumers for over a century is functioning well, and getting better.

We appreciate the committee's interest in this important area. The National Association of Insurance Commissioners stands ready to provide you with whatever additional assistance you may require.

NOTES

1. In this context, an "accredited" reinsurer is one which submits to the State's jurisdiction and authority to examine its records, is licensed to transact insurance or reinsurance in at least one State, files its annual statement each year, and either (a) maintains a policyholder surplus of at least $20 million and whose accreditation has not been denied by the Commissioner within 90 days of its submission, or (b) maintains a policyholder surplus of less than $20 million and whose accreditation has been approved by the Commissioner.

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